BMO Financial Group

Q4 2013 CONFERENCE CALL

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Assumptions about the level of default and losses on default were material factors we considered when establishing our expectations regarding the future performance of the transactions into which our credit protection vehicle has entered. Among the key assumptions were that the level of default and losses on default will be consistent with historical experience. Material factors that were taken into account when establishing our expectations regarding the future risk of credit losses in our credit protection vehicle and risk of loss to Bank of Montreal included industry diversification in the portfolio, initial credit quality by portfolio, the first-loss protection incorporated into the structure and the hedges into which Bank of Montreal has entered.

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Non-GAAP Measures

Bank of Montreal uses both GAAP and non-GAAP measures to assess performance. Readers are cautioned that earnings and other measures adjusted to a basis other than GAAP do not have standardized meanings under GAAP and are unlikely to be comparable to similar measures used by other companies. Reconciliations of GAAP to non-GAAP measures as well as the rationale for their use can be found in Bank of Montreal's Fourth Quarter 2013 Earnings Release and Bank of Montreal's 2013 Management's Discussion and Analysis, all of which are available on our website at www.bmo.com/investorrelations.

Examples of non-GAAP amounts or measures include: efficiency and leverage ratios; revenue and other measures presented on a taxable equivalent basis (teb); amounts presented net of applicable taxes; adjusted net income, revenues, provision for credit losses, specific provision for credit losses, expenses, earnings per share, effective tax rate, ROE, efficiency ratio and other adjusted measures which exclude the impact of certain items such as credit-related items on the acquired M&I performing loans, run-off structured credit activities, M&I integration costs, amortization of acquisition-related intangibles, decrease (increase) in collective allowance for credit losses and restructuring costs.

Bank of Montreal provides supplemental information on combined business segments to facilitate comparisons to peers

PRESENTATION

Operator

Please be advised that this conference call is being recorded. Good afternoon, and welcome to the BMO Financial Group's Q4 2013 earnings release and conference call for December 3, 2013. Your host for today is Ms. Sharon Haward-Laird, Head Investor Relations. Please go ahead.

Sharon Haward-Laird - *Bank of Montreal - 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 Frank Techar, Chief Operating Officer, Mark Furlong from U.S. P&C, Gilles Ouellette from Wealth Management and Tom Milroy from BMO Capital Markets. We will end the call with comments from each of our group heads on our business outlook.

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.

I would also remind listeners that the Bank uses non-GAAP financial measures to arrive at adjusted results to assess and measure performance by business and the overall Bank. Management assesses performance on a reported and adjusted basis and considers both to be useful in assessing underlying business performance. Bill will be referring to adjusted results in his remarks. Additional information on adjusting items, the Bank's reported results and factors and assumptions related to forward-looking information can be found in our annual MD&A and our fourth quarter report to shareholders.

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

Bill Downe - BMO Financial Group - President and CEO

Thank you, Sharon, and good afternoon everyone.

BMO's fourth quarter results mark the finish to a year in which the Bank achieved record net income and record earnings per share. This performance reflects a well-executed growth strategy and the benefits of a diversified business model. Today, we announced a dividend increase lifting our annual dividend to over 3 dollars a share.

BMO's U.S. segment generated over $1 billion in earnings in 2013, benefiting from continued business growth, particularly strong results in Wealth Management and Capital Markets, and good credit performance.

In U.S. P&C, our commercial business is performing very well and small business banking pipelines have strengthened, while personal banking continues to be impacted by low rates.

With the pace of U.S. economic growth expected to be stronger and with consumers continuing to deleverage, we're well positioned given BMO's geographic diversification, large commercial banking business, integrated North American Platform, and a strong unified brand.

Canadian Personal & Commercial banking had record earnings this year. We delivered robust volume growth contributing to notably stronger revenue and income in the second half. We also demonstrated good expense discipline through process simplification and the reduction of non-customer facing positions.

And, senior leaders have new roles as we've reorganized to get even closer to customers. These changes have made us more consistent in execution and agile in responding to customers' needs, fostering the dialogue that builds long-term loyalty.

Wealth Management had a record year with earnings up significantly and increased market share, supported by strong asset growth and customer loyalty.

Our Canadian retail businesses are both heading into 2014 with very good momentum.

We recently appointed Frank Techar as Chief Operating Officer to lead our North American personal, commercial and wealth businesses, allowing for greater operating consistency.

As COO, he'll ensure our investment in both people and technology is deployed to continually enhance the customer experience while lowering the cost to serve. Frank has deep knowledge in both Canada and the U.S. and will draw on cross-group capabilities to grow profitability and market share.

BMO Capital Markets had a good year with solid earnings growth and strong return on equity. Market uncertainty associated with the tapering of quantitative easing and the U.S. debt ceiling was a damper on the fourth quarter.

As Sharon said, Tom Flynn's remarks will focus on the fourth quarter and I'll provide my perspective on the year as a whole, speaking to adjusted numbers. Of note, the difference between reported and adjusted earnings over the last twelve quarters has been less than 1%.

We had a record year with $4.3 billion in earnings[1] or $6.30 per share[1], both up 5%. Revenues increased to $15.6 billion and return on equity was 15%.

We paid out 47% of earnings as dividends to common shareholders in fiscal 2013. In addition, we repurchased 10.7 million shares under our normal course issuer bid.

In the year, volume growth was robust with loans up 8% and deposits up 11%.

Credit performance was good -- provision for credit losses were down from last year. Surjit will comment on credit later in the call.

We ended the year with a Basel III Common Equity Tier 1 ratio of 9.9% - a very strong position and a differentiator.

Concurrent with the Q4 earnings release today, we announced our intention to renew a Normal Course Issuer Bid, subject to regulatory approvals.

Share buybacks continue to be a useful capital management tool, and when combined with dividends, provide an attractive return of capital to shareholders. We returned over 60% of earnings to common shareholders this year through a combination of dividends and buybacks.

Turning briefly to the operating groups:

Canadian P&C net income[1] for the year was a record at $1.9 billion, up 4%.

Total loans were up $15.6 billion or 10% and deposits were up $7.4 billion or 7%. Commercial deposit growth was particularly strong, up 12% with good market share gains year over year.

Good expense management and improved revenue growth produced strong operating leverage of 2.7% in Q4.

1 – on a reported basis: Full year earnings were $4.2B or $6.26 per share up 1% and 2% respectively; Revenues increased to $16.3B; P&C Canada net income was $1.9B, up 4% for the year.

We continue to implement system and process enhancements that allow our front-line employees to spend more time winning new customers and increasing share of wallet.

U.S. P&C net income[1] for the year was $633 million in source currency.

Our Commercial Banking team had another strong year -- core C&I loans increased $3.5 billion or 19% from a year ago.

In Personal banking, we've been doing the right things to attract new customers and we're seeing results -- checking and saving deposits were up 8% in 2013.

The low rate environment continues to weigh on interest earnings in the short-run, however, our deposit rich balance sheet will be a source of increased returns when rates rise.

Fiscal uncertainty temporarily impacted consumer and small business sentiment and the mortgage sector has cooled.

But, despite these negative factors impacting the consumer segment, growing loans and deposits has an immediate payoff which will increase over time.

We're earning the trust of customers with strong brand awareness and community presence. BMO Harris Bank ranked number one out of thirty major U.S. banks in long-term trust in the 2013 American Banker and Reputation Institute Survey.

In Business Banking, we've been very active in customer calling and the pipeline is up 30% from a year ago. There are good growth opportunities in this business.

Wealth Management posted annual net income[1] of $861 million with wealth businesses separately contributing $600 million -- both records.

Assets under management and administration were up $66 billion or 14%.

Our U.S. in-house fund family, BMO Funds, has grown to $11.6 billion in AUM. Over 85% of BMO Funds' assets are in the first quartile over a five-year period, as measured by Lipper.

BMO Capital Markets had a good year with earnings[1] up 7% to $1.1 billion and ROE was strong at 19%.

In the U.S., we saw good progress with net income over $200 million. The capabilities we've built in the U.S., including expanded distribution, focused research and coverage in strategic sectors are contributing value -- both in improved profitability and increased competitiveness of our Canadian offering.

We expect to see continued improvement in the contribution from our U.S. business going forward.

In total, 2013 was a year of progress against our strategic priorities while generating the best one year total shareholder return among the Canadian banks at 29%.

Our three-year average annual EPS growth rate was approximately 9.4%, in line with our 2013 medium-term objective to achieve average growth of 8 to 10 percent.

ROE was within our 15% to 18% target and we maintained strong capital ratios, exceeding regulatory requirements.

We did not meet our medium-term operating leverage objective given softer revenue growth than we had anticipated.

We've demonstrated consistent expense discipline, and improved operating leverage in the second half of 2013 gives us confidence we'll do better on this measure going forward.

Our medium term objectives for 2014 remain largely unchanged. The EPS growth range has been updated to 7 to 10 percent to be consistent with where the industry is in the cycle.

1 – on a reported basis: U.S. P&C net income for the year was US$596MM; Wealth Management annual net income was $834MM; BMO CM earnings were up 7% to $1.1 billion

To conclude, we have clear opportunities for growth across a diversified North American footprint and good operating leverage across our U.S. businesses.

With strong market positions and proven strengths both sides of the border, our large commercial platform positions us well.

There's good momentum in Canadian P&C and our wealth franchise has strong growth opportunities in North America and select global markets.

We'll focus on efficiency through core operations and technology integration, particularly for our retail businesses across North America.

Over the last 3 years, we've made structural changes in our technology architecture and have completed a large systems conversion and integration process. These accomplishments demonstrate our ability to execute against our strategic priorities.

A strong capital position continues to give us flexibility and we're confident in our ability to earn industry-leading customer loyalty to increase market share and drive revenue growth.

I want to thank our customers for their loyalty and all our employees for their commitment to the bank and to our customers.

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

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Tom Flynn - BMO Financial Group - CFO

Thanks Bill and good afternoon everyone. Bill has covered the annual results, so my focus will mainly be on the quarter.

Turning to slide 9, adjusted net income[1] was $1.1 billion. From an operating perspective, we had continued momentum in Wealth Management and in Canadian P&C in the quarter. We also had higher securities gains which were partially offset by softer results in Capital Markets due to lower trading revenue and higher taxes, and by credit provisions which were higher in the quarter.

Adjusting items reduced reported net income by $14 million and are detailed on Slide 31.

Moving now to slide 10, Q4 adjusted revenue[1] was $4.1 billion, up 4% both year-over-year and quarter-over-quarter.

Adjusted net interest income[1] was up 1% year-over-year, with good volume growth in Canadian P&C and continued loan growth in US P&C offsetting lower NIM. Adjusted net interest income[1] was down 1% from Q3 due to lower trading net interest income and NIM.

We had good growth in adjusted non-interest revenue[1] which was up 6% year-over-year driven by higher securities gains and mutual fund revenues, partially offset by lower trading revenue. Non-interest revenue[1] was up 10% quarter-over-quarter largely due to higher securities gains partially offset by lower trading and insurance revenue.

The stronger US dollar increased adjusted revenue by 2% year-over-year.

Turning to slide 11, expenses continue to be well managed. Q4 adjusted expense[1]s were $2.5 billion, up 3% year-over-year, or up just 1% adjusting for the stronger US dollar. The small year-over-year increase was primarily driven by higher employee-related costs, including pension, and higher regulatory-related costs.

Adjusted expenses[1] were up 2% from Q3 largely due to higher technology and advertising expenses.

1 – on a reported basis: Q4 net income was $1.1B; revenue was $4.2B, up 3% Q/Q and flat Y/Y; net interest income was down 3% both Q/Q and Y/Y; non-interest revenue was up 4% Y/Y and 10% Q/Q; Expenses were $2.6B down 4% Y/Y, up 2% Q/Q

As you know, we have a new accounting standard on pensions coming in next year. This will increase annual pension expense by approximately $65 million pre-tax. I also note that, as we do every year, we will record costs related to employees eligible to retire in the first quarter of next year.

As shown on slide 12 the Basel III Common Equity Tier 1 ratio remains strong at 9.9%. The ratio is up 30 basis points from last quarter due primarily to higher capital levels. Risk weighted assets were relatively consistent with Q3 levels.

Looking forward to next quarter, we have the credit valuation adjustment, or CVA, capital charge beginning to phase in, and this will reduce the ratio by approximately 20 basis points in Q1.

Moving to slide 13, Canadian P&C continues to demonstrate the momentum we saw last quarter with revenue growth[1] of 4% and adjusted net income[1] growing 6% to $472 million.

Loan growth continued to be good, with both personal and commercial loans up 11% year-over-year.

On the deposit side growth was also good, up 9% year-over-year, and our continued focus on commercial deposits resulted in balances increasing 14% year-over-year.

NIM was down 3 basis points quarter-over-quarter with this driven mainly by changes in mix.

Expenses were up just 2% year-over-year and flat compared to last quarter.

With the revenue growth and low expense growth Canadian P&C ended the year with positive operating leverage of 2.7% and an efficiency ratio of 50.6%, 130 basis points better than last year.

Lastly, with respect to PCL, Commercial provisions were higher this quarter primarily due to one commercial account.

Moving to slide 14, US P&C adjusted net income[1] was US$113 million, down year-over-year and from Q3 with above trend provisions in both the consumer and commercial portfolios.

The benefits of continued strong commercial loan growth were offset by lower margins resulting in revenue of US$693MM, down 8% year-over-year. Revenue was down 2% quarter-over-quarter driven primarily by lower mortgage related non-interest revenue. Net interest income was relatively unchanged from Q3 as good loan growth offset a 10 basis point decline in NIM due to competitive pressures and continued deposit spread compression.

Expenses were 3% lower year-over-year as selective investment in the business and higher regulatory-related costs were more than offset by synergy-related savings. And lastly as mentioned earlier, credit provisions were high this quarter compared to what we experienced through the year.

Total loans were up 3% year-over-year and up 1% quarter-over-quarter. Core C&I loan growth continued to be strong with balances up 19% from last year.

Turning to slide 15, BMO Capital Markets adjusted net income[1] was $229 million which is below levels we have seen for the past year. The fourth quarter last year included particularly strong trading revenues and a recovery of prior periods' income taxes.

Revenue was down 11% year-over-year due to lower trading revenues given the strong quarter a year ago and also due to market uncertainty this quarter associated with tapering of quantitative easing and US Debt ceiling, partially offset by higher M&A and debt underwriting fees.

Expenses were down year-over-year primarily due to lower performance-based costs, and up 1% from Q3 due to increased technology costs.

Moving on to slide 16, Wealth Management continued to show strong operating momentum with adjusted net income[1] of $319 million.

1 – on a reported basis: P&C net income grew 6% to $469 million; U.S. P&C net income was US$102 million; BMO Capital Markets net income was $229 million; Wealth Management net income was $312 million

Net income was up significantly in part from a $121 million security gain. This investment has continued to perform well and has contributed to the growth in unrealized securities gains in the quarter.

Our other wealth businesses performed very well with adjusted net income[1] up 38% year-over-year. Strong growth was driven by higher client assets, increased transaction volumes and a continued focus on productivity. Q4 performance was consistent with the record performance of the prior quarter.

Insurance results were good, with adjusted net income[1] of $69 million in the quarter.

Adjusted expenses[1] were up 7% year-over-year primarily due to higher revenue-based costs and higher marketing spend to drive future revenue growth.

Turning now to slide 17, the Corporate segment had a net loss[1] of $36 million on an adjusted basis compared to net income of $41 million a year ago, and was relatively unchanged from Q3.

Adjusted revenues were lower year-over-year due to a decline in treasury-related items and a variety of other items none of which were individually significant. Quarter-over-quarter adjusted revenues improved primarily due to a lower group teb offset.

Adjusted recoveries of credit losses were lower year-over-year and from Q3 largely reflecting reduced recoveries on the purchased credit impaired loan portfolio. As a reminder, all acquired loan accounting items are recorded in the Corporate segment.

Adjusted expenses were higher year-over-year primarily due to higher pension and benefit costs, and regulatory-related costs, partially offset by lower technology costs. The quarter-over-quarter expense increase was primarily driven by technology costs.

To close, we had record net income and EPS for fiscal 2013 and feel confident about how our businesses are positioned heading into 2014 as we will talk more about later.

With that, I will turn it over to Surjit.

Surjit Rajpal - BMO Financial Group - Chief Risk Officer

Thank you Tom and good afternoon everyone.

I will start on slide 20. Specific provisions excluding the purchased portfolio were 244 million dollars, an increase of 91 million dollars from the previous quarter. The increase was primarily from our P&C businesses in both Canada and the US.

The quarter-over-quarter change in U.S. P&C consumer provisions is due to enhancements to identify borrowers who have declared bankruptcy but are still current with their payments. For such borrowers, the loans must be classified as impaired and written down to the value of the collateral, in accordance with regulatory guidance. This had a 24 million dollar impact on US Consumer provisions this quarter, absent which the US consumer performance improved.

We also saw higher PCLs in both the U.S. and Canadian commercial portfolios. As I have said on previous calls, there can be variability in commercial provisions; this quarter we had a few accounts on which we took provisions.

I do not view the PCL increase as symptomatic of an underlying trend as the US economic environment continues to improve and conditions in Canada remain stable.

Looking at the full year, U.S. P&C Commercial PCL's were significantly improved at 26 basis points, compared to 37 basis points in 2012. Canadian commercial PCL's were slightly higher at 28 basis points compared to 25 basis points.

Overall, total PCL's, excluding the purchased portfolios, were 32 basis points in 2013 - a 10 basis point improvement over 2012.

1 – on a reported basis: other wealth businesses net income up 39% Y/Y; Insurance net income was $69 million; Corporate net loss was $28 million

The recovery on the purchased credit impaired portfolio was 104 million dollars for the quarter which was lower than last quarter. Recoveries for the full year were 410 million and were better than expected.

Given that the portfolio is now down to about a fifth of its original size, recoveries will moderate both in size and pace. As in previous periods, we will continue to take advantage of market opportunities through workouts and sales to resolve these portfolios.

Moving to the next slide, total Bank formations were largely flat to last quarter at 614 million dollars.

Gross impaired loans continued their declining trend this quarter and decreased as a result of lower formations in the purchased performing portfolio. GIL's as a percentage of Gross Loans and Acceptances, including purchased portfolios, are now at 91 basis points.

From a credit perspective, we had a good year in 2013 and I expect continued good performance in 2014 given the quality of our book and the economic outlook.

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

QUESTION AND ANSWER

Operator

The first question is from Robert Sedran with CIBC. Your line is now open. Please go ahead.

Robert Sedran - *CIBC World Markets - Analyst*

I appreciate that the medium-term targets that the bank sets out are exactly that. They are not meant to be applied to the upcoming year. But in contemplating the growth rate that we might think about for next year, would we be using $6.30, the adjusted number from this year as the base, or would you counsel us to think of the growth into 2014 in a different way?

Bill Downe - *BMO Financial Group - CEO*

No, Rob. Thanks for the question. We view the $6.30 as a starting point.

Robert Sedran - *CIBC World Markets - Analyst*

And so, again, I know you aren't providing me with a guidance range in terms of the upcoming year, but is the Board looking at 7% to 10% off of that as a way it's looking to look at management's performance next year?

Bill Downe - *BMO Financial Group - CEO*

Well, I won't speak for the Board. We set the medium term targets and strive to achieve them every year, recognizing that some years we may be above, but over time, this is the range we expect to operate in. And it basically allows for the vagaries of things that might happen in a year that are not in the ordinary pattern.

Robert Sedran - *CIBC World Markets - Analyst*

Okay, and Surjit, to come back to the purchase credit impaired, I know it's hard to give a lot more granular guidance than what you've given, but is there anything more you can give us comparing 2014 to what we saw in 2013? It seems pretty clear that 2013 was better than you expected a year ago on that front. Is there the potential that 2014 could be better than what you're expecting as well, or is it just the size of the portfolio has gotten to a point where it has to trail-off meaningfully, just by definition?

Surjit Rajpal - *BMO Financial Group - Chief Risk Officer*

You're correct in saying that the size of the portfolio is significantly lower. It's about 20% of where it was and in some ways, the surprise we had, or I should say, the better than expected performance we had in 2013, does impact what we can do in 2014.

That said, the portfolio is rather small, so if I was looking at where we could possibly be for the whole of next year, I would say we would be in the region of, let's say, $100 million give or take, and probably a little weighted towards the early part of the year. And with the value maximization strategy, as you can tell, there are lots of things that happen.

Some of this portfolio is already migrating to performing. We are restructuring some part of it. Some part gets repaid, and some part of it gets refinanced and of course we do opportunistically look at loan sales as well. So I would say for 2014 $100 million plus or minus would be a good number.

Robert Sedran - *CIBC World Markets - Analyst*

Thank you for that.

Operator

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

Peter Routledge - *National Bank Financial - Analyst*

Thanks for actually doing this on your own day. It helps.

Question on P&C Canada. Quite strong loan growth, and Frank, I'll invite you to just give us your thoughts on what's going well there.

The other thing that struck me was that NIMs were down, and I'm kind of wondering why. And I guess the first question that comes to mind is 100% of your newly originated loans in the year coming from BMO's branch network?

Frank Techar - BMO Financial Group - Chief Operating Officer

Thanks, Peter. I assume when you're asking those questions, you're asking about the mortgage growth. We did have strong loan growth across virtually all of our products including our commercial businesses, as Tom and Bill have already pointed out.

The mortgage growth though, I just might take a minute for that one, and start at the beginning. We do, as you know, have the smallest portfolio of the big five banks in Canada, and therefore, we've got a little room to grow.

We also view the mortgage business as attractive. It's one of those products where we can bring new customers into the Company, and we've been successful in doing that over the last couple of years.

And we have had the objective to grow faster than the marketplace as part of our strategy, which I've talked about in the past as well. So I would only say that we've been successful based on our recent performance, and we're hoping to continue to build on that in the future.

We have grown as a result of a couple of things. The first one is we've had great products in the marketplace, products that have been attractive to customers looking to purchase homes, and we've also had great products because they've helped us from a retention perspective. Our five-year product is definitely helping at this point in time, as fewer people are refinancing.

And on top of that we've had strong sales management performance in our proprietary channels, so if you look at our mortgage growth, which over the course of the year has been in the mid double digits, our proprietary channel growth has been double digits as well. Growth is coming from our branches and from our mortgage specialist sales force.

So for all those reasons, I'm happy with the growth in our mortgage business, and we're going to continue to do everything we can to grow as rapidly as we can, recognizing that we're doing it with our normal prudent, consistent, conservative underwriting standard as well.

Peter Routledge - *National Bank Financial - Analyst*

Are you experimenting with third party channels for mortgage origination?

Frank Techar - BMO Financial Group - Chief Operating Officer

We have funded third-party mortgages every year that I've been associated with the business. We do it opportunistically, based on return and quality criteria, and overall, the third-party mortgage book represents a small percentage of our mortgage business.

Peter Routledge - *National Bank Financial - Analyst*

So you wouldn't say that's the reason why your NIM came down? There are other factors other than that?

Frank Techar - BMO Financial Group - Chief Operating Officer

Well I would say that our mortgage growth being as strong as it is, is having an impact on margin. But I would also just point out that over the last two quarters, our margin was down 4 basis points. I think I guided towards 2 to 4 basis points a quarter, so it has actually been at the low end of the range.

And I'd also point out the fact that our net interest income is up quarter-over-quarter. So we're still growing our revenue at a time when our NIM is continuing to be under pressure, more so from competitive pressure than the growth in our balance sheet.

Peter Routledge - *National Bank Financial - Analyst*

Okay, thank you.

Operator

Thank you. The next question is from Mario Mendonca with TD Securities. Please go ahead.

Mario Mendonca - *TD Securities - Analyst*

Two quick questions. First for Mark Furlong, and this is very broad.

Looking at the second half of the year, and it was a little more challenging the second half. Do you think it would be a reasonable expectation that US P&C earnings growth could be positive in 2014? Do you think you can actually grow earnings from the base that we saw in 2013?

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Well, of course, I think we could grow earnings from the base you saw in 2013. The early part of the year, we will have a little margin compression that we will work through, it should neutralize itself by the end of 2014. But as you see in the net interest income line, the loan growth has about offset the declines in margin.

The mortgage business is changing a little bit in the US more to the purchase side, so that's going through its normal evolution right now. We'll manage expenses really well in 2014, but we feel pretty good about where the business is at.

The commercial business and business banking pipelines are still very strong. Home equity business is very strong in the US. We still have the average age of an auto in the US at around 11 years, so we expect that business will continue to be strong. So we have pretty strong expectations about what we will do in 2014.

Mario Mendonca - *TD Securities - Analyst*

Part of the reason I asked the question is the revenue growth -- the non-interest revenue growth in this segment this quarter, you referred to lower mortgage revenue. Are we talking about lower gains on securitized mortgages, or is there something else?

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Actually, we went up a little bit. The change this quarter was just the revaluation of the pipeline, what's going through the portfolio, and the pipeline is down in a seasonal low here, as we get near holiday. But I expect it will begin to come back up in 2014, so I wouldn't read anything into that.

I think we'll have a good mortgage year next year, and expect that in spring we'll continue to see a lot of home purchases in the US. I think one of the interesting things about the US is that we see like the Case Shiller data come out, and it talks about the increase in home prices, and we forget that we have a big chunk of our business that sits right in the Midwest, and Chicago really only had a few months strung together with home price increases, and the same for Wisconsin.

So both of those Markets are still coming back strongly, they are both under water from the peak, in the neighborhood of about 20%. So both are coming back strong now and that creates upside on the home purchase side, it creates upside on the home equity side, and unemployment is coming down still, which is also positive.

Chicago is a little bit over the national average, Wisconsin is a little bit under, and that's where our biggest density is in terms of customers and the biggest MSAs that we have concentration. So both those markets are still strengthening. So we feel pretty positive about all of the markets we're in right now, and their opportunity to grow next year.

Mario Mendonca - *TD Securities - Analyst*

So I was a little confused by that. You said the revaluation of the mortgage pipeline?

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Yes, so in the US, we do a mark-to-market every quarter on what's in the pipeline, based on the probability that it will fund. And so, we had a lower pipeline at the end of the fourth quarter than we did at the end of the third quarter, but expect that pipeline to grow into 2014. So I would say future fundings would be a little bit lower for the next quarter or so, but expect to see good growth in 2014.

Mario Mendonca - *TD Securities - Analyst*

Okay, thank you.

Operator

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

Steve Theriault - *BofA Merrill Lynch - Analyst*

Thanks very much. For Frank to start, please. Frank, I see headcount is down almost 800 in the quarter. I think that's the biggest swing I can recall seeing, could you give us a little color on that?

And if you could also speak to expenses, lost in maybe the credit noises, it was a very good quarter on expenses. So can you talk a bit about your degree of confidence you'll see meaningful positive operating leverage next year? And I have a quick follow-up for Tom Flynn as well.

Frank Techar - BMO Financial Group - Chief Operating Officer

Yes, thanks, Steve. Your two questions are related a bit. We did see a big reduction in the headcount. Two factors there. One is our continuing work in improving our processes and efficiency, and so that's good news, and I would just say that those are sustainable changes as we look into 2014.

For the quarter, we overshot a little bit. We do have some outstanding vacancies that I would expect will fill as we go into the first quarter or two. So the number is probably a little low this quarter relative to our expectation for a run rate going forward.

My expectation for 2014 is we're going to have a better year, and part of that is the operating leverage improvement that we've seen over the last two quarters is going to continue. So we will continue to manage our expenses well.

We did that in 2013, in the early part of the year. As you know, we just didn't have the revenue growth to cover it, and I'm certain that the momentum we have seen in the last half of the year is going to continue into 2014.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Okay, certain. I like that. And then just for Tom Flynn, on the tax rate, you either mentioned or I noticed it was a little higher this quarter. Can you remind us of what you've highlighted in the past as a sustainable tax rate? And is there anything going on tax-wise that might make us worry that the number could head higher over the next year or two?

Tom Flynn - *BMO Financial Group - CFO*

The guidance we've given around the tax rate is to point people to a number in the low 20s, and that continues to be the kind of range we would point people to. In the current quarter the rate was high.

Relative to that, it was 22.4%, and it was higher because of higher levels of income in foreign jurisdictions subject to higher taxes, and the main driver there was the security gain in the US. And we also had lower levels of tax-exempt income.

I would point out as well that in Q4 of last year, the tax rate was quite low. It was I think 17.9%, so it is a factor in the year-over-year performance that we've had this quarter.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Is there anything in particular driving the lower tax-exempt income?

Tom Flynn - *BMO Financial Group - CFO*

Not really. It moves around from quarter to quarter, so I would say not really, and we're comfortable with the guidance we've given in the past, and really aren't moving off that.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Thanks.

Operator

Thank you. The next question is from Michael Goldberg with Desjardins Securities.

Michael Goldberg - *Desjardins Securities - Analyst*

Do you want to remind us what your operating leverage objective is medium term, and for 2014? And what flexibility do you have in expenses to achieve it?

Tom Flynn - *BMO Financial Group - CFO*

It's Tom, Michael. The medium term target that we have around operating leverage is operating leverage of 2%, and we're focused on achieving that in 2014 through good revenue growth and continued good performance around expense management. We feel very good about that P&C Canada operating leverage in the quarter, which is 2.7%.

And Frank has talked about his expectations heading into next year from a revenue and an expense perspective, and the likelihood of good performance continuing from an operating leverage perspective in that business, which is almost half of the total.

On the wealth side of the business, we continue to have good revenue growth in the traditional business, and I would say very good productivity management in that business as well.

And in our US capital market business, where we've made significant investments, we've had stronger performance during this year. And we expect that to continue into next year driving positive operating leverage. So we've got, we think, a pretty good line-up relative to the target for the year, and expect to have positive operating leverage, given the revenue outlook and the continued focus on productivity.

Michael Goldberg - *Desjardins Securities - Analyst*

And in both Canada and the US separately, maybe Frank and Mark can just comment. Do you think that we're at the bottom of the net interest margins, or if not, how far away, what has to happen before we get to the bottom?

Frank Techar - BMO Financial Group - Chief Operating Officer

Michael, just from a Canadian perspective, again I'll repeat our expectations for NIM in the Canadian P&C business would be 1 to 2 basis points a quarter pressure on margins as we move forward, and there are two things that continue to be at play.

The first one would be the low interest rate environment; To the extent we see rates rise, in particular the term rates, we'll see that pressure abate.

And the second one is just normal competitive pressure with respect to the business we're doing, in particular on the commercial side.

So they are continuing to play out, and my expectation is that will continue as we look into 2014.

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

And then in the US, I don't really think my perspectives change much. I mean the range is probably something like 4 to 8 basis points compression, on a quarterly basis, and that will bottom out toward the end of the year. Our expectation is that we'll see rates begin to rise near the end of the year, and that will be a positive for us.

We are asset sensitive in the US, and there's some pretty material upside to that position, and we feel relatively good about where we're at. In the interim, our job is to make sure we can grow the balance sheet at a speed that will offset the margin decline.

I think we're in a decent position by the end of the year.

Michael Goldberg - *Desjardins Securities - Analyst*

Thank you.

Operator

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

John Aiken - *Barclays Capital - Analyst*

Bill, with your capital levels at 9.9%, now I know that Tom mentioned the phase in the CVA will cost about 20 basis points, but taking a look at this philosophically, do you actually need to run at a close to 10% ratio over the medium term? Or should we actually expect risk weighted asset growth to accelerate and overtake the accumulation of capital?

Bill Downe - *BMO Financial Group - CEO*

John, it's a good question. As I said at the outset, we do think organic growth will be stronger, so I think business growth is going to have the ability to absorb some proportion of the capital.

If you look at 2013, I think the way that we handled the generation of capital is really quite striking in the context of the larger competitive environment. We bought back $670 million worth of shares. We paid $1.9 billion of dividends, and we increased the common equity of the Bank by $1.9 billion.

And what that demonstrates is the earning power of the Bank, and what happens when you have a strong starting capital position. It gives you options and choices, and we really haven't had the kind of underlying loan growth within the US footprint that I think I would categorize as a more normal loan growth on the personal side. We've had strong in commercial, but on the personal side, not nearly as strong.

So I do think there will be absorption. And as all of the businesses grow, they will use more capital, but we've been able to demonstrate having the buyback available gives us a very good outlet for the excess capital, and it certainly paid off in 2013.

John Aiken - *Barclays Capital - Analyst*

Great, thanks, Bill.

Operator

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

Brad Smith - *Stonecap Securities Inc. - Analyst*

I was just wanting to talk a little bit about the securities gain in the US, and understand better exactly how that happened. And I mean, was that just a straight out sale of a portfolio, and if so, what was the underlying value of it at the time?

Tom Flynn - *BMO Financial Group - CFO*

It's Tom, Brad. The security gain resulted from a change in the accounting treatment in an investment, from equity accounting to available for sale accounting. And under IFRS, when you have that change, you mark the investment at market, and take a gain equal to the difference between the market value and our cost.

So our cost at the time was about $100 million. The total value of the security was around $290 million and the pre-tax gain was the $190 million. The investment has continued to perform well since we remarked it, and going forward, under the accounting, we'll take changes in the share price through OCI until realized, and when realized through the P&L.

And this is an investment related to a relationship we had with a wealth management firm in the US, it has been a very good relationship for us through time, and the investment has done very, very well. So we're pleased with the relationship we've had and the performance of the investment.

Brad Smith - *Stonecap Securities Inc. - Analyst*

So then Tom, just as a follow-up, there was no cash impact from this gain realization. Am I to understand that you expect to have these types of gains going forward?

Tom Flynn - *BMO Financial Group - CFO*

The answer to the first question is that's correct, and I think we would absolutely expect to have continued security gains. And every quarter we have security gains in our business.

This quarter, they were higher given the gain that we had. Other security gains happened to have been relatively low in the quarter, and so I'm not sure that we'll expect gains at this level, but they will be part of the mix of our revenue going forward, as they have been in the past.

Brad Smith - *Stonecap Securities Inc. - Analyst*

Great, thank you.

Operator

Thank you. The next question is from Gabriel Dechaine with Credit Suisse. Please go ahead.

Gabriel Dechaine - *Credit Suisse - Analyst*

Just wanted to follow-up on that NIM question for the US. Mark, you seem pretty confident it's going to settle out at the end of next year. If you could talk about what are some of the assumptions there, that the CRE run-off or the legacy stuff is nearing its end?

It sounds like you're expecting a rate increase, or is it the bulk of the securities portfolio and the loan portfolio just having repriced at the low rate, and more competitive environment? If you can go through some of your thoughts there, I'd appreciate it.

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Sure. The deposit portfolio is settling in at what I think is about the level where it's at. We've seen little competition.

On the lending side, I think that will begin to neutralize itself in kind of the middle of next year. The new assets we're adding, of course, are slightly lower spreads than some of the assets that we have on the books.

And then we expect a rate rise at the end of the year, and I think that will have kind of a neutering effect on the decline in the margin. But when you're forecasting this out three or four quarters, this is an estimate based on what we think is going to happen, and we try to be conservative, and we try to be accurate, but that's what it is, it's an estimate.

And so the last two quarters, we had a little more rate compression than I thought. I think the 4-8 range that I answered one of the earlier questions with is a pretty reasonable expectation for what I see happening in the next couple of years. After that, I'm sure it's a little bit rougher when you look at the estimate.

Gabriel Dechaine - *Credit Suisse - Analyst*

Okay, and then given the revenue headwinds we've seen over the past year, we've seen the mix in the US moving up rather than down, as many had hoped. Wondering, are you willing and able to bring expense growth, and make it even more negative than it currently is, or is reinvestment holding that back?

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Well, we have done some reinvestment in the business. We've been relatively flat with expenses. Near the end of the quarter, you can see the FTE count is down, and that happened more near the end of the quarter.

So as you look at the mortgage business as we look at some things we've done in the branches for example, half of the system was using a branch scheduler, based on transaction activity and time of day, and the other part of the branch franchise we rolled that scheduler in, and that freed up some personnel that we reallocated elsewhere.

So we'll continue to use technology to find ways to manage our expense levels. But I think we'll be able to keep expenses relatively neutral during 2014, compared to where we entered 2013. We'll make some investments, we'll find some sales opportunities where we have the right mix of folks to add, but we'll be pretty judicious about what we do on the expense side.

Gabriel Dechaine - *Credit Suisse - Analyst*

Actually if I can sneak one more in for Tom. We can spend a lot of time talking about the segments, but the biggest delta in adjusted earnings for the year was in corporate. It was nearly $300 million, that's on an adjusted basis.

You talked about, let me see here, the higher pension expenses. Next year, I guess the credit recoveries are going to be maybe a quarter, so down $300 million.

I'm wondering, are there any positive offsets or some expenses embedded in what we saw, revenue items we saw in the corporate segment that are going to flip around and turn positive next year, to offset some of those items? Or what should we model for corporate?

Tom Flynn - *BMO Financial Group - CFO*

Corporate is a tricky segment to model, because the numbers move around and we've got some residual Treasury related items in there. If you look at the performance of corporate over the last six quarters, and you exclude loan losses in total, the recoveries and otherwise, the number would be around an average of negative $100 million. I think heading into next year, we would hope to have some upside on the corporate revenue line, with that reflecting a better rate environment, and the PCLs will move directionally, in the way that Surjit talked about.

Not all of the pension item will end up in corporate, because we do allocate expenses out, and the majority of that pension expense will get allocated out, with other expenses to the relevant operating group. I might if I could, just go back very quickly from your comment as well on expenses in P&C US and in US dollars, the expense line for the year was down year-over-year, by I think it was about 4%, so we did have synergies coming in offsetting the reinvestments in the business and some regulatory costs that Mark talked about on a US dollar basis.

Gabriel Dechaine - *Credit Suisse - Analyst*

And if I'm interpreting Mark correctly, so next year closer to flat, is that it?

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Yes, there will be closer to, I mean the fourth quarter expense level is a relatively good indicator of where I think expenses will be. Some quarters will be up a little bit, some down a little bit, but don't expect a big rise in expenses in 2014.

Gabriel Dechaine - *Credit Suisse - Analyst*

Okay, thanks.

Operator

Thank you. The last question is from Mario Mendonca with TD Securities. Please go ahead.

Mario Mendonca - *TD Securities - Analyst*

Asked and answered, thank you.

Bill Downe - *BMO Financial Group - CEO*

Okay, that's great. Thanks very much for your questions. I appreciate it. Let me turn the call over to our business heads, and get some comments on the outlook from their perspective and we'll start with Frank, and then Mark, Gilles, and Tom Milroy will finish up.

Frank Techar - BMO Financial Group - Chief Operating Officer

Okay thanks, Bill. A number of these points that I think I've already made in responding to some of the questions, but in looking at Canadian P&C banking this year, we did have record earnings of $1.9 billion, and maybe most importantly, we ended the year with really good momentum, which I continue to expect to see more of in 2014.

We've made progress on productivity, focusing on streamlining our processes and investing in our channels. And we're going to continue to improve our branch, online, and mobile capabilities and streamline our front line processes in support of our customer experience and efficiency objectives.

With the strong balance sheet growth continuing, a moderating margin pressure, and stronger non-interest revenue growth, I expect revenue growth to continue to improve in 2014 above the 4% levels that we saw in the second half of 2013. I continue to believe our strategy is working, and I expect, as I said earlier, 2014 to be an even better year than 2013 for Canadian P&C.

I'd just maybe close by saying that a month into my new role as Chief Operating Officer has only reinforced my belief that, in our retail, commercial and wealth businesses we've got many opportunities to redefine ourselves and work more efficiently and capitalize on our North American scale that we have built over the last few years. So with that, I'll turn the mic over to Mark.

Mark Furlong - BMO Financial Group - Group Head, U.S. Personal and Commercial Banking

Thanks, Frank. In US P&C, we had over $600 million in adjusted income this year. This is a similar level to last year, as strong C&I loan growth overcame headwinds from low rates, competition in commercial banking, and the run-off of non-strategic portfolios.

I see a number of positive signs as we head into fiscal 2014. First would be, commercial grew new clients by 10% last year, adding to a strong mix of customers. C&I loan growth has consistently been in the mid to high double digits all year, and we expect strong growth in 2014.

In commercial real estate, we added over $2.1 billion in new commitments and you began to see that growth at the end of fiscal 2013. The pace of adding new business banking customers has increased by almost 75% since the start of the year, with the pipeline 30% higher than at the same time last year.

We continue to have significant opportunities, and in October, we had the highest level of business banking calls in the entire year.

In personal banking, we grew personal checking and savings deposits 8% in 2013, and that will be a strong source of cost-effective funding as we grow our consumer loan book.

These positive factors will help to offset ongoing margin and competitive pressures. Revenue growth will continue to be difficult the first half of 2014, but as I mentioned, we should begin to see origination volumes and balance sheet growth overcome competitive pricing in the second half of the year, which will positively impact revenues and earnings. And with that, let me hand it off to Gilles.

Gilles Ouellette - *BMO Financial Group - Group Head, Wealth Management*

Great, thanks Mark. We had a good 2013, and we have good momentum, and feel quite optimistic about 2014.

Our assets this year grew by 14%, and that's really without much help from the Canadian market until the fourth quarter. And since, as you know, most of our businesses are fee businesses, the increase in assets results in revenue growth.

Also, in the last quarter, the tone of the market improved, and we think that should help transaction volumes. We've made a number of changes in our businesses in last few years, and that's led to higher satisfaction scores and a number of industry awards.

Clients are saying that they like what we're doing, and we think that should help us grow our client base. And if there's a pick up in interest rates in the latter part of the year, this should help us in our insurance business, but also our spread business, because the spread revenues are important to some of our wealth businesses.

So we've had a good 2013 and we expect a very strong 2014. With that, I'll pass it on to Tom.

Tom Milroy - *BMO Financial Group - Group Head, BMO Capital Markets*

Thanks, Gilles. We had a good year in Capital Markets with net income growth of 7% and an ROE of 18.9%. We believe the Canadian business is diversified and well positioned across the market, and we would expect this business to continue to perform well going forward. The capabilities we built in the US are making an increasing contribution to our results, with very good net income growth this year, and we're making an acceptable return.

We expect continued growth in revenue, net income and ROE from our US segments. It's worth noting that our US capabilities also enhance the competitiveness of our Canadian offering.

I feel confident about our prospects for continued growth, coming from our continued focus on adding core clients across the North American platform. Bill, over to you.

Bill Downe - *BMO Financial Group - CEO*

Thanks, Tom. Let me summarize. We're heading into next year with confidence and momentum across our businesses.

Investment in corporate banking provides capital markets with operating leverage against a recovery in financing and M&A.

In our largest business, Canadian P&C, our balance sheet is the strongest it has ever been, with growth in both personal and commercial segments across both loans and deposits, and we expect improved revenue growth to continue in 2014.

US P&C performance will continue to be led by our strength in commercial banking, while we position personal and small business banking for improved profitability and winning new customers. And all segments of wealth management start from a very strong competitive position, and a growing base of managed and administered assets.

I'd like to take a moment now finally to pay tribute, as many have done, and are doing today, to our longtime friend, Paul Desmarais, Sr. As a Company that has its roots in Montreal, we have a great appreciation for all he accomplished for the business community in the city, and for Quebec, and for Canada as a whole.

Mr. Desmarais was a great Canadian with a global outlook. He garnered respect from around the world. As an entrepreneur, he set the standard for others. On behalf of everyone at BMO, we offer our condolences to his family and friends.

And as this is our last call for the year, again I'd like to say thank you to both the analysts and the investors who follow the Bank so closely, and wish everyone the best for the holidays. Thanks for joining us, and good afternoon.