BMO Financial Group

Q2 2014 CONFERENCE CALL

CORPORATE PARTICIPANTS

Sharon Haward-Laird
Head, IR

Bill Downe
Chief Executive Officer

Frank Techar
Chief Operating Officer

Tom Flynn
Chief Financial Officer

Surjit Rajpal
Chief Risk Officer

Tom Milroy
Group Head,
BMO Capital Markets

Cameron Fowler
Group Head
Canadian P&C

Mark Furlong
Group Head
US P&C

CONFERENCE CALL PARTICIPANTS

Rob Sedran
CIBC World Markets

Sumit Malhotra
Scotia Capital

Steve Theriault
BofA Merrill Lynch

Gabriel Dechaine
Canaccord Genuity

Peter Routledge
National Bank Financial

Doug Young
Desjardins Capital Markets

Darko Mihelic
RBC Capital Markets

Meny Grauman
Cormark Securities

Mario Mendonca
TD Securities

Sohrab Movahedi
BMO Capital Markets

PRESENTATION

Operator

Good afternoon, and welcome to the BMO Financial Group's Q2 2014 Earnings Release and conference call for May 28, 2014. Your host for today is Ms. Sharon Haward-Laird, Head of Investor Relations.

Ms. Haward-Laird, please go ahead.

Sharon Haward-Laird - *BMO Financial Group - Head, 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 question and then re-queue.

Also with us this afternoon are Frank Techar, Chief Operating Officer, Cam Fowler from Canadian P&C, Mark Furlong from U.S. P&C, Tom Milroy from BMO Capital Markets and Gilles Ouellette from Wealth Management.

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 and Tom will be referring to adjusted results in their remarks unless otherwise noted. 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 report and our second quarter report to shareholders.

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

Bill Downe - *BMO Financial Group - CEO*

Thank you, Sharon, and welcome to everyone on the call.

BMO's second quarter results demonstrate continued momentum and strong performance across the operating groups.

Our largest business, Personal and Commercial banking in Canada, did really well with net income growth of 14% year-over-year. Commercial loan growth remained robust in Canada and the U.S. Our large North American platform provides attractive growth opportunities, especially in the current environment.

Wealth Management and Capital Markets also had strong results in the quarter, both posting double digit revenue and earnings growth.

In sum, our business groups' performance resulted in positive operating leverage and good balance sheet growth with earnings per share[1] up 13% from last year.

And, today, we announced a dividend increase reflecting the success of our business strategies which are grounded in the work we do for customers: taking deposits, facilitating payments, providing credit, helping them make better decisions with better information, and to have confidence in the decisions they make.

A few highlights from our second quarter. Both reported and adjusted net income were $1.1 billion. Pre-provision pre-tax earnings[1] reached $1.5 billion, up 11% from a year ago and earnings per share[1] were $1.63. Revenue[1] grew 9% from last year contributing to positive operating leverage[1] of 1.2%. Credit was stable in the quarter. Surjit will provide more detail later in the call.

BMO's Common Equity Tier 1 ratio was 9.7% at the end of April. With the strength in our Common Equity Tier 1 ratio heading into 2014, we had the flexibility to announce the acquisition of F&C in the first quarter which closed on May 7th.

In an environment where capital expectations for banks have been increasing internationally -- we believe, as a general principle, that moving back to a Common Equity Tier 1 ratio between 9.5 and 10% is appropriate and provides flexibility.

Turning to the operating groups:

Canadian P&C continues to demonstrate momentum with net income[1] up 14% to $482 million. Strong organic balance sheet growth continued -- driving revenue growth of 6%. Combined with disciplined expense management, operating leverage was 3.3%. The business has delivered operating leverage above 2% for three consecutive quarters and has shown solid improvement in the efficiency ratio.

U.S. P&C net income[1] was $151 million in source currency. Revenue was stable quarter over quarter largely due to robust commercial loan growth which lifted total loans up 7% from a year ago and 4% sequentially. Expenses were well controlled while we invest for future growth and absorb increased costs from a higher level of regulatory engagement. Our commercial banking team continues to excel, with growth across the core C&I portfolio as well as in Commercial Real Estate.

BMO Capital Markets reported strong results with net income over $300 million. Revenue growth was 14% reflecting strength in both Investment and Corporate Banking and Trading Products. And, return on equity increased to approximately 21%.These results reflect continued solid contribution from the U.S. business, where earnings are up 15% in the first half of this year.

Wealth Management also had a strong quarter with net income[1] of $200 million, up 36% year over year. Assets under management and administration were up 17% to over $600 billion.

The acquisition of F&C significantly increases our client assets which will be reflected in our third quarter. F&C is the proud manager of Foreign and Colonial Investment Trust -- founded in 1868 as the world's first publicly listed pooled investment vehicle. The addition of F&C advances BMO Global Asset Management's strategy and growth trajectory. Today, our asset management business has 24 offices in 14 countries across five continents serving an increasingly global client base. Our multi-disciplined teams are headquartered in Toronto, Chicago, Hong Kong and London with a network of investment specialist boutiques strategically located across the globe.

Our strengths span asset classes with a broad range of investment solutions across various geographies including equities, fixed income, and multi asset solutions -- such as target date funds and liability driven investing.

To wrap up, strong operating group performance resulted in another quarter with consistent earnings over $1 billion. For the quarter and year to date, continuing business momentum is reflected in positive operating leverage and good balance sheet growth. And, with our consistent strategy and areas of operational focus, we're confident that this will continue into the second half.

1 – on a reported basis: Earnings per share were up 14%; Pre-provision pre-tax earnings were $1.4 billion, up 8% from a year ago; Earnings per share were $1.60; Revenues grew 4% from last year contributing to positive operating leverage of 1.9%; Canadian P&C net income up 14% to $480MM; US P&C net income was US$140MM; Wealth Management net income was $194MM, up 38% year over year

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

Tom Flynn - *BMO Financial Group - CFO*

Thanks Bill and good afternoon everyone.

I'll now take you through our results, starting on slide 8. We delivered EPS[1] of $1.63 this quarter, which was up 13% year-over-year. Net income[1] was $1.1 billion. Year to date performance is also good, with revenue[1] growth of 9% and EPS[1] growth of 10%.

As Bill said, our operating group results were strong. Canadian P&C continued to demonstrate momentum and Wealth Management and Capital Markets made strong contributions to our earnings growth. Good loan growth in US P&C contributed to stable quarter-over-quarter revenue.

Similar to last quarter, the only adjusting item in Q2 is the amortization of acquisition-related intangibles.

Revenue[1] was $4.0 billion in the quarter, up 9% from last year. Looking at the components of this growth, net interest income[1] was up 5% year-over-year driven by volume growth, revenue from the purchased performing loan portfolio, and the impact of a stronger US dollar, partially offset by lower net interest margin. Net interest income[1] was down 2% sequentially in large part due to fewer days.

Non-interest revenue[1] was up 13% from last year driven by higher non-interest revenue in almost all categories. Non-interest revenue was down 2% from Q1 primarily due to lower underwriting and advisory fees, trading revenue and fewer days.

Q2 expenses[1] were $2.6 billion, up 8% year-over-year. The increase reflects business growth, the impact of a stronger US dollar, and higher employee and technology costs related to a changing business and regulatory environment. Expenses were down from Q1 primarily due to costs related to employees eligible to retire in the first quarter, lower severance costs and fewer days.

The efficiency ratio[1] improved 80 basis points from the prior quarter to 63.5%. Some peers calculate the efficiency ratio excluding certain costs, including claims related to the insurance businesses, which are outlined on the slide. On a similar basis, our Q2 efficiency[1] ratio is much lower at 58.8%.

The effective tax rate[1] was 16.5%, down from last year. The rate was 24.4% on a TEB basis, which is relatively in-line with prior quarters.

Moving to slide 9, our Common Equity Tier 1 Ratio was 9.7%, up approximately 40 basis points from Q1 due to lower source currency risk weighted assets and increased retained earnings. Risk weighted assets declined $5 billion from Q1, due to reduced market risk exposures and lower credit risk, which was primarily due to improved risk assessments and the favorable FX movement in the quarter, and these were partially offset by updates to calculation methodologies. As a reminder, the F&C acquisition will impact our third quarter CET 1 ratio by approximately 75 basis points.

Moving to our operating group performance in the quarter, starting on slide 10, Canadian Personal and Commercial Banking demonstrated continued momentum with revenue growth of 6% and net income[1] of $482 million, up 14% from last year. Organic balance sheet growth was strong with personal loans up 9% and commercial loans up 10%. Personal and commercial deposits were up 10% and 9% respectively.

1 – on a reported basis: EPS of $1.60 was up 14% Y/Y; Net income was $1.1B; YTD revenue growth of 3% and EPS growth of 9%; Revenue was 4.0 billion in the quarter, up 4% from last year; Net interest income decreased 3%Y/Y; Net interest income was down 2% sequentially; Non-interest revenue was up 12% from last year; Efficiency ratio improved 90 basis points from prior quarter to 64.2%; Efficiency ratio excluding PBCAE of 59.4%; Effective tax rate of 16.2% down from last year; Effective tax rate of 24.4% on a TEB basis; Canadian P&C net income of $480 million up 14% from last year

NIM was down 3 basis points from last quarter due to changes in mix, including loan balances growing faster than deposits.

Expenses[1] were up 3% year-over-year in part reflecting on-going work to simplify core processes and investment in the business which will continue over the balance of the year. Expenses[1] were down 4% from Q1 primarily due to lower employee costs, including fewer days.

Our execution focus is driving strong operating leverage in the business, which was 3.3% in the quarter and the efficiency ratio improved 160 basis points from last year to 50.2%.

Moving to US P&C on slide 11, net income[1] was US$151 million, down from Q1, which had a low level of PCLs. Pre-provision, pre-tax earnings[1] increased 4% quarter-over-quarter.

Revenue of $691 million was down 3% from last year as loan growth, driven by sustained double digit growth in core C&I loans, was more than offset by lower NIM and mortgage related revenue. Revenue was stable quarter-over-quarter despite the impact of fewer days. The net interest margin declined primarily due to strong commercial loan growth. Loan and deposit spreads remained fairly stable.

Expenses are being managed closely and were relatively flat year-over-year and down quarter-over-quarter.

Turning to slide 12, BMO Capital Markets had a good quarter with net income[1] of $306 million, up 17% year-over-year and 10% from Q1. Revenue growth of 14% reflects the benefits of our diversified business mix, including continued good contribution from the US segment.

Expenses were up 14% from last year due to higher employee-related expenses and costs related to a changing business and regulatory environment. Expenses were down 5% sequentially due to lower severance, and costs related to employees eligible to retire in Q1.

As Bill mentioned, ROE remains strong at 20.8%.

Moving on to slide 13, Wealth Management net income[1] was $200 million, up 36% year-over-year. Strong performance in traditional wealth continued with net income up 23% and revenue up 11% driven by growth in client assets. The underlying Insurance business continued to perform well, with income significantly higher than last year. The prior year results were impacted by movements in interest rates.

Expenses[1] were up 7% year-over-year primarily due to higher revenue-based costs.

Assets under management and administration were up 17% driven by market appreciation, the stronger US dollar and growth in new client assets.

Turning now to slide 14, the Corporate segment had a net loss[1] of $58 million compared to a net loss of $11 million a year ago and $41 million in the prior quarter. The declines were primarily due to lower credit related recoveries, partially offset by lower expenses in the current quarter.

To conclude, we had good results across our operating groups this quarter and for the first half of the year, and are heading into the second half of the year with good momentum.

With that, I will turn it over to Surjit.

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

Thank you Tom and good afternoon everyone.

1 – on a reported basis: P&C Canada expenses up 3% Y/Y and down 4% Q/Q; U.S. P&C net income of US$140 million down from Q1; Pre-provision, pre-tax earnings increased 5% Q/Q; Capital Markets reported net income of $305MM up 17% Y/Y and 10% Q/Q; Wealth Management net income of $194 million up 38% Y/Y; Expenses up 7% Y/Y; Corporate segment reported net loss of $58 million compared to reported net loss of $11 million a year ago and $41 million in the prior quarter

Our credit performance was good this quarter, reflective of continued improvement in the US economic environment and stable conditions in Canada.

Starting on slide 17, excluding recoveries in the purchased credit impaired portfolio, specific PCL improved by $9 million. Recoveries in the purchased credit impaired portfolio were down $72 million from the prior quarter, as the remaining portfolio is considerably smaller and almost half is performing.

In Canada, commercial losses were in line with expectations. Consumer losses increased from their low levels in Q1 but are down 5% year over year and 10% year to date.

Losses in the US consumer portfolio were flat, while U.S. Commercial losses increased $31 million. This increase was due to a few large accounts, compared to last quarter where recoveries fully off-set new reservations.

Moving to the next slide, formations were $509 million, down $133 million from the prior quarter. The decrease was broad-based, with reductions in Commercial and Consumer in both Canada and the U.S.

Gross impaired loans also decreased this quarter to approximately $2.3 billion, reflecting improvement in the US portfolio. In fact, over the past year, US gross impaired loans have decreased by approximately $500 million, or 24%.

In conclusion, given the quality of our portfolio and our strong risk management practices, I expect our credit performance to remain good. I will now turn it over to the operator for the question and answer portion of today's presentation.

QUESTION AND ANSWER

Operator

(Operator Instructions)

Rob Sedran, CIBC.

Rob Sedran - *CIBC World Markets - Analyst*

Hello, good afternoon. Actually first, just a quick clarification from you Tom, when you talk about 75 basis points for F&C, is there an operational risk-weighted asset component to that, or is that all to goodwill that comes with the deal?

Tom Flynn - BMO Financial Group - CFO

There would be an operational risk component to the capital number, but the biggest number obviously is the goodwill.

Rob Sedran - *CIBC World Markets - Analyst*

Okay. And just my question actually is on trading, and Tom Milroy, I guess there's been a number of notable moves, not just in the overall number, but the components equity and foreign exchange are both quite strong. Can you perhaps comment on what specifically worked well?

And then on a related note, and maybe this flips back to Tom Flynn, the tax rate seemed a little on the low side on a reported basis but the TEB tax rate seemed closer to normal. So is the tax issue related to the trading this quarter?

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

Okay, it’s Tom Milroy, I'll take the first question. And thanks for the question actually, because I was hoping I'd get to talk because it was a really strong quarter that is built on the solid foundation of the first quarter, and we feel really good about the business and about how we're benefiting from the diversified business mix that we have.

So when you look at the trading numbers, let me talk first to the rates, and then I'll get to equity and FX. And you saw the big swing between interest rate and equity. Interest rate trading was really a function of, I would say, two major factors.

One was our own name spread, which narrowed, which has a negative impact on P&L. And then generally, in the space we had much lower issuance, particularly in the government area. And less activity, so that's what happened in that piece.

In terms of equity, we benefited from several large client-related transactions, combined with strong equity market performance, low equity volatility, and we experienced higher retail note issuances. So they all combined to give us the swing you saw on equity.

If you go to the FX trading line, which also was strong, it was really a result of higher client activity. In particular, the weaker Canadian dollar helped our export clients, and so we saw a lot of activity as they were doing more business, and that was a plus. The other thing was, that we benefited from good performance from our FX business in China, where with the band on the RMB, they were able to post some pretty good results.

Tom Flynn - BMO Financial Group - CFO

It's Tom Flynn. I'll just go to the consolidated bank tax part of the question.

I think you really led to the answer in your question. The TEB tax rate for the bank was about 24.4%, very much in line with the typical number. The effective tax rate is somewhat low this quarter at 16.5%, and that simply reflects the higher level of TEB revenue in capital markets flowing through to the tax rate and the comments that Tom mentioned.

Rob Sedran - *CIBC World Markets - Analyst*

Thank you.

Operator

Sumit Malhotra, Scotia Capital.

Sumit Malhotra - *Scotia Capital - Analyst*

Good afternoon. The question relates to Canadian P&C, and wanted to start off first with your outlook on loan growth.

BMO has obviously had some of the stronger consumer loan growth in the sector over the past couple of years now, and it seemed, at least on the consumer side, to slow pretty noticeably. Hoping you can give us an update on what you're seeing here, and whether or not that relates to perhaps a slowing in some of the third-party mortgage activity the bank has been involved with?

Cam Fowler - *BMO Financial Group - Group Head Canadian P&C*

Thanks, Sumit. It's Cam Fowler speaking here. Thanks for the question.

The first thing I'd say is this is clearly a strong quarter for us. We're pleased with the net income, the revenue that's driving it, and the balance sheet growth, on both sides of the business. We're also pleased with the operating leverage, third quarter straight.

The consumer lending piece, specifically, while it is true that things are a little bit lighter quarter-on-quarter, I feel that's primarily driven by a slower mortgage market in part driven by weather. We ourselves were a little bit later starting this year in the mortgage season, Sumit.

That said, activities are back up to the volumes we'd expect, and I think we'll close the season quite well. And I expect Q3 to be stronger, and that we'd finish the year quite well on the personal lending side.

We have, just to your specific point with respect to third-party, stayed involved in this to some degree or other over many years. We have dialed this down slightly in recent quarters, but I think, primarily, this is more the force on activity in the market.

Sumit Malhotra - *Scotia Capital - Analyst*

Just to take the temperature a little bit here, Cam. Obviously BMO had had faster than industry growth on the consumer side, and particularly in mortgages, for two or three years now. Is it your expectation, and I know you don't have the full picture on what your competitors may or may not be doing on the pricing side, but is it your expectation that you will revert back to above industry average growth in the near-term, or do you feel it's more aligned now?

Cam Fowler - *BMO Financial Group - Group Head Canadian P&C*

Pipelines are strong. We think that the home finance strategy that we've been undertaking for the past three years, which is pretty focused on what's best for Canadian consumers, shorter amm., lower LTV, the fixed rate, that the distribution system is pretty efficient at having these types of conversations with our customers and our prospects now. So, I expect that we can continue to be a little bit better than the market.

Sumit Malhotra - *Scotia Capital - Analyst*

Thanks for your time.

Operator

Steve Theriault, Bank of America Merrill Lynch.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Thanks very much. If I could just start with a quick follow-up back to Tom Milroy. On the equity trading, you mentioned several large client-related transactions. So I guess those are equity derivative transactions I guess. And I'm wondering if those are the total return swaps that bank undertakes, and if there's any seasonality to that line of business.

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

Let me answer it. It is in the equity derivative area, but I wouldn't say it's seasonal. It's client driven, so you end up depending on what your clients are doing, that line will go up and down.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Okay. And if I could ask Tom Flynn, I saw in the notes you mentioned a changing calculation methodology. I apologize if you answered this in your commentary, but that's partially what was an offset in the risk weighted asset category.

So another bank this quarter flagged updated risk parameter updates. Is that similar to what we're seeing here from you today, and could there be more to come on this front? If you could just give us a little more granularity there.

Tom Flynn - BMO Financial Group - CFO

Yes, I'm not sure what was going on elsewhere, but every quarter, as you know, you go through processes related to looking at your models and your risk positions. And so this quarter, there was a change related to that work. I would say it was nothing out of the ordinary, and we wouldn't expect anything out of the ordinary in this area going forward.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Okay. So it was more normal course, it wasn't a review centered on retail and commercial or anything specific it doesn't sound like?

Tom Flynn - BMO Financial Group - CFO

That's correct.

Steve Theriault - *BofA Merrill Lynch - Analyst*

Okay. Thanks Tom.

Operator

Gabriel Dechaine, Canaccord Genuity.

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Good afternoon. The first question I have is on the purchased performing loans. About a $15.5 billion portfolio[1] and it's performing, so the NII is going through corporate, correct?

Tom Flynn - BMO Financial Group - CFO

That is correct.

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Okay. And then as far as the US goes, I guess a two-pronged question here. Can you quantify the mortgage gain on sale that you had this quarter, and what it was a year ago, and what's a normal number?

And then on the US NIM trajectory, a little bit weaker than I was expecting. Not on a sequential basis, nothing to get all worked up about. But on a year-over-year basis, it doesn't look like the trend is getting better.

And I know, Mark, you've talked in the past about the pace of NIM compression improving over time. And I'm wondering if that's still on track, or if some of the loan growth that we're seeing is actually above average and the loan growth we're seeing is the offset of that and that NIM is going to stay lower for longer.

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

Okay, so thanks for the question. So I'm going to go to the last one first, the NIM question and see if I can go at both of those. So I think one was what's happening with NIM, and the other one is what's happening with loan growth. Is that a good way to translate it?

1 – Net interest income related to the credit mark on the purchased performing portfolio is recorded in Corporate; the balance of net interest income earned on purchased performing loans is recorded in U.S. P&C

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Yes. You're a lot more straightforward than I am.

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

I want to answer your question correctly. So on NIM, my outlook is improving. We previously thought we'd have about 4 to 8 basis points of NIM compression this quarter. We now think prospectively maybe it's like 2 to 4 basis points, and there will be variability in between quarters.

Those quarters that have really strong loan growth, that strong loan growth will effect margin by a few basis points, would be my guess right now. But overall, when we look at that loan growth, it's driving revenue growth, and we like the diversity, and we like the credit quality, and the new relationships we're adding.

In terms of prospectively and in loan growth, if that was part of the question too, I think this was a really strong quarter. So I don't know that every quarter will look like this. But we like the pipelines in commercial and in business banking, and we have a strong position in our biggest markets.

In both of those, we feel good long-term about those. We're putting up double digit loan growth in C&I and commercial real estate, as well as in our business banking. And you can't bet on one quarter on it's own, but if you looked at it prospectively, we expect that we'll have good solid loan growth prospectively when you look across year-over-year numbers.

So did I get to where you wanted to get to on those two questions?

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Yes. And if you can talk -- well maybe I'll re-queue for the other one. The mortgage gains would be something I'm interested in.

Frank Techar - *BMO Financial Group - COO*

Gabriel, it's Frank. On the mortgage gain question, Q2 2013, the gains were $19 million and this quarter $7 million. Just to be really specific.

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Somewhere in between there normal, or how should I look at that?

Frank Techar - *BMO Financial Group - COO*

As you know, it's volatile quarter-to-quarter, but within this range.

Gabriel Dechaine - *Canaccord Genuity - Analyst*

Okay. Thank you.

Operator

Peter Routledge, National Bank Financial.

Peter Routledge - ***National Bank Financial - Analyst***

Hello, thanks. A question for Surjit. Surjit, I think credit is probably about as good as we've seen it. And I suppose in your job, you've always got to ask yourself, well how could it get worse.

And I actually don't want to ask you that. What I want to ask you is how likely is it in your mind that it stays this good for an extended period of time? What's the argument that this lasts for two or three years?

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

I think the argument that this could carry on for a while is that the recovery of this last cycle has been very slow, and the economies still are improving. The US is improving, Canada is stable, and barring something happening that no one can predict, I think this may carry on the way it is for some time.

So given our two principal markets, I think we are very positive on the US. And Canada, there seems to be no reason to be really concerned about. So I think this can carry on for a bit.

Peter Routledge - ***National Bank Financial - Analyst***

And for you to change your mind on that, what would have to change in the broader environment? What are you looking at?

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

I think at this point in time, I would say since it would have to be a sudden or a shock event, I can't think of anything that would cause things to get off the rail other than some event on the geopolitical front that I can't really foresee at this point in time.

But you're right, the question you were planning to ask me and you didn't ask, at this point in time, I think things are good. But at some point in time, the cycle will change. But it doesn't seem like it's on the horizon right now.

Peter Routledge - ***National Bank Financial - Analyst***

Fair enough. Thanks for that.

Operator

Doug Young, Desjardins Capital Markets.

Doug Young - *Desjardins Capital Markets - Analyst*

Sorry, I had you on mute there. So the first question is just on the US PCI purchased credit impaired book. And I think, if I recall back in Q4, you guided to $100 million pretax for 2014. I think we're at $162 million year-to-date over the first two quarters. And I was just wondering if you have an update in terms of your thoughts on a glide path for that portfolio?

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

Let me give you a little bit of flavor. I think in my remarks, I did say the portfolio is small. It's about $600 million right now, and roughly half of it is performing. So that leaves us a very small portfolio, and the accompanying mark is $12 million.

So the variables you are dealing with are very different from what they were let's say 6 or 12 months back. So I do expect recoveries, and the recoveries will exceed the mark. Because when we bought the portfolio from M&I, M&I had already taken some reservations against that portfolio.

So if my guidance was not good two quarters back, it was because it's very difficult to time some of the sales and the work out that happens with these accounts. Now given that the portfolio is small, I think there's not too much left in it. But I would think in the next quarter, we'd have a decent quarter, I think the recovery will exceed the mark.

But then the portfolio will have come down slower. So I would suggest that for the balance of the year, it is going to be less than the first part of the year clearly, a lot less.

Doug Young - *Desjardins Capital Markets - Analyst*

Is it conceivable by the end of next year that there is no further adjustments on this portfolio? Is that fair to assume?

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

Highly likely, but it all depends. Highly likely that we won't have much of it left by then.

Doug Young - *Desjardins Capital Markets - Analyst*

Okay. And then just a quick second question, on the F&C transaction, just wondering if you've finalized all the purchase price details? And I would imagine you're going to in your adjusted numbers back out associated amortization, and just wondering if you have a sense of what that impact would be on a quarterly basis?

Tom Flynn - BMO Financial Group - CFO

Hello, it's Tom Flynn. Given that the acquisition just closed a couple of weeks ago, we're still working on finalizing the purchase price. So we don't yet have the amortization number. Our plan is to back it out like we back out the other intangible amortization that we've got.

And we'll also have some integration charges. They won't be that significant in the context of the bank, but we'll be incurring those over the next few quarters. And the plan would be to adjust for those as well.

Doug Young - ***Desjardins Capital Markets - Analyst***

Okay. Thank you.

Operator

Darko Mihelic, RBC Capital Markets.

Darko Mihelic - ***RBC Capital Markets - Analyst***

Hello, thank you. A couple of questions. The first is, I'm wondering with respect to the expense control in the Canadian P&C, or maybe perhaps you can speak about this in the context of an operating leverage. Can you just remind me what kind of operating leverage are you looking for for the balance of this year?

What do you think is a more sustainable level? And then I have a follow-up question with respect to loan growth please.

Cam Fowler - ***BMO Financial Group - Group Head Canadian P&C***

Darko, it's Cam Fowler, and thanks for the question. With respect to operating leverage, we expect revenue to continue along a similar trajectory, and our expense profile is relatively consistent. So, operating leverage in line with an average of what we've done in the last few quarters, perhaps not quite what happened this quarter, but not far off the two before that.

Darko Mihelic - ***RBC Capital Markets - Analyst***

And so just to be clear, expense growth in the 2% to 3% range is normal? And as I recall, if I sit back and think about the previous couple of years, there was an awful lot of initiative spend at Bank of Montreal within Canadian P&C. And the sense that I'm getting is somehow that's slowed or stopped. Am I wrong in that thinking?

Cam Fowler - ***BMO Financial Group - Group Head Canadian P&C***

I think that thinking is not quite right. What I would say is, we continue on a similar revenue trajectory. I think expense, as you've laid out, is in the range, 2% to 3%. Maybe a little more or a little less from time to time.

We've been on a relatively consistent track with respect to investment though in the business in the last three or four years, spikes here or there, but the platform renewal continues. We just work very hard to ensure that it's paced in such a way that we don't have any blips. But I think positive operating leverage in the 2 per cent-ish range is decent guidance.

Darko Mihelic - ***RBC Capital Markets - Analyst***

Okay, thanks for that. And then maybe just to follow-up on the loan growth questions. Two things, first, with respect to the mortgage promotions and this year you're a little bit late with the promotion.

My sense is that the other banks seem more competitive this year than last. They may not have actually copied the product, but they certainly are getting more aggressive with rates. And even today, I think we saw Scotia with a more aggressive rate offer. Can you speak to whether or not that's having an impact?

And then similarly, last year when we looked at your commercial loan growth versus peers, you were clearly ahead. Now it seems as though many of the Canadian banks are also putting up impressive commercial loan growth numbers. Is there more competition now in commercial, and if it is, is that also affecting the overall margin in the Canadian P&C business?

Cam Fowler - ***BMO Financial Group - Group Head Canadian P&C***

Okay. Thanks. Let me start with the first one.

It's possible there's a little more competition in the home finance market this year than last, but I don't think to a large degree. I think we're all observing a slightly later start, a slightly slower market for reasons that we've all talked about.

If I look at where activity went to through the quarter, it's picked up, as I said, to the levels that we'd expect. And, if I look at the pipeline that we are say looking to close, I don't think that there's a disproportionate amount of competition hitting that that would affect our outcome. So yes, there's competition, but I think we'll bear up just fine against it, and it wouldn't affect the results.

Moving to the commercial loan side, I would still characterize the competition out there as healthy. We have a large and strong franchise. We've been focused on diversification.

Our pipelines are really very strong. I can't comment specifically on what others are doing. I wouldn't say there's disproportionate pressure from any one player in any particular region, and we're confident that we'll keep up our momentum in a meaningful way on the commercial business.

Darko Mihelic - ***RBC Capital Markets - Analyst***

Thank you for that. That's good color. And then just lastly, could you speak to credit cards? A lot of noise being made by competitors.

We continue to see Bank of Montreal somewhat in a different position on the credit card scene. Is there anything on the horizon, or should we just view the credit card portfolio as one that's not going to be an area of strong growth for Bank of Montreal?

Cam Fowler - ***BMO Financial Group - Group Head Canadian P&C***

I wouldn't like you to view it that way. I think that the cards business is an important one. It's critical to our growth aspirations, it's critical to our loyalty aspirations.

To be sure, it's an area that we haven't perhaps done as well on in past years. The past four quarters, we've had a great deal of emphasis on the business, and I think we're starting to see some pretty pleasing results. We've focused on renewal of the team there, the platform is new, we've had product renewal, we've had a very large focus on the premium segment.

We are looking right now at some positive metrics. We're originating across all card categories at double-digit. We're acquiring in the premium segment at multiples of last year. We've acquired more premium cards in the first half of this year than we did all of last year, one-fifth of those are new to bank. Then other metrics like balances, active accounts, net retail sales, they're all up. So, we consider this to be good momentum in a business that's really critical to us, and I expect the back half of the year to be stronger in card.

Darko Mihelic - *RBC Capital Markets - Analyst*

Okay. Thanks for the color.

Operator

Meny Grauman, Cormark Securities.

Meny Grauman - *Cormark Securities - Analyst*

Hello, good afternoon. The first question is on capital, and you're targeting a CET1 ratio between 9.5% and 10%. It seems a little bit higher than the thinking before, and then some of your peers have mentioned this quarter. I'm wondering what the change is, and what's driving this extra conservatism?

Bill Downe - *BMO Financial Group - CEO*

Thanks for the question, Meny. I would characterize it as a pretty consistent, as opposed to a change in trajectory for BMO. If you think about the last five years, we moved our capital ratio up ahead of the market. We're very clear going back really all the way to 2010 about where we thought CET numbers would start to pan out.

The reason why we were very comfortable entering into a discussion to acquire F&C Asset Management, which was really a significant company and is going to be a significant contributor, as we finished 2013 with the ratio at 9.9%. And since that time, you can just see the level of discussion more broadly in the United States and Europe around where capital levels will finish.

I think there are a number of jurisdictions where they're talking about levels above the 10%, and I think it has a lot to do with mix of assets in specific geographies in bank portfolios. I think at the 9.5% to 10% range, the balance is about right between having the flexibility to do things when the opportunity arises, and capital levels that are not too high to allow banks to competitively intermediate credit in the market.

So what we're talking about I think is, just clarity around the range that in the ordinary course provides the maximum flexibility to take advantage of opportunities, and at the same time, be efficient for shareholders, and the way that we can balance that is between dividends, share buybacks, acquisitions. And what we're hoping for is a little faster economic growth in the developed world, which probably means that in 2015 and 2016 absorption of capital retained from growing the balance sheet.

Meny Grauman - *Cormark Securities - Analyst*

And then just to follow-up on the discussion of loan growth and margin, I understand the trade-off between the two. And the question is, why would you prefer to sort of err on the side of loan growth at the expense of margin versus the other way around? How would you explain that?

Bill Downe - *BMO Financial Group - CEO*

I guess, let me answer the question generically. I think you're asking a relatively generic question. It's really matter of mix.

And in certain loan categories, and I would say the commercial loan business, while the margins in the market have reset, they still represent a very attractive return on capital. And that's the sector of the market that's growing. So in a single asset class, your question might prevail, are you trading margin against the volume?

But when you talk about the business mix, what we're talking about is growing the whole balance sheet and optimizing the return to the shareholders on capital. So I think there isn't a discrete trade-off in a single product, in a single market, it's the overall balance sheet growth. And we're fortunate that with the business mix that we have and the capabilities that we have, that we can demonstrate strong performance in commercial banking on both sides of the border.

Meny Grauman - *Cormark Securities - Analyst*

Thank you.

Bill Downe - *BMO Financial Group - CEO*

You're welcome

Operator

Mario Mendonca, TD Securities.

Mario Mendonca - *TD Securities - Analyst*

Good afternoon. First, for Tom Flynn, clean up question. To what extent did interest recoveries in the US aid the margin? Last quarter, it was something like 3 basis points.

Tom Flynn - BMO Financial Group - CFO

It was sort of a measurable number last quarter. This quarter it really did not have an impact on the margin.

Mario Mendonca - *TD Securities - Analyst*

Okay. Then a follow-up question to this loan growth in the US, and this is probably best for Mark Furlong. C&I loan growth, commercial real estate loan growth, quarter-over-quarter, and I appreciate we're talking about a base that's relatively small, but that quarter-over-quarter growth is pretty significant now.

I'm not so much interested in what's going on with the margin, because I follow the explanation you're offering here that the margin has been reset or the rates have been reset. But is there anything going on in terms that would have driven such a significant growth in a given quarter?

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

So this is Mark again. So, good question. In the sector for commercial in the US, that isn't the area that's under structure changes on deals, both in C&I or commercial real estate. There has been different periods of good competition on price, but in cases I can tell you where we have seen structure changes which aren't a lot, and we don't participate in it.

The growth that we've had has really been across all of our sectors and across all of our geographies, and it's one quarter, and I'm talking about the last rolling three to five quarters. If one quarter, one sector, one geography didn't grow, then it grows the next quarter, and something else maybe doesn't grow for a quarter. So when you look year-over-year, all of them have had growth.

So it hasn't been weighed down, the growth hasn't been weighed down by one sector or one market or one of anything. It really has been broad-based across the portfolio.

Then too, you have to recall then when we were going through a merger and an integration, you necessarily get some of that internal distraction. And we had some of it too. And then, it's learning new rules, and learning a new credit process, and the team coming on.

And so, that causes a slowdown in part of the business, but then of course picks up once everyone gets comfortable. And I think what you're really seeing now is the company coming into its the seasoning of a team working together really well, it feels like we've been in the same company for years and years now. Everybody understands process, and understands what's acceptable in the credit box, and you just have this great chemistry working across the business. And that's what I think you're seeing in the commercial and the business banking units really in particular.

Mario Mendonca - *TD Securities - Analyst*

Now, Mark, you've characterized the pricing this time around on the new business, the new commercial loans coming on as being lower than what's on the books now. And that's one of the explanations of why the margin has come down, so I think that's clear to me. Could you offer a similar comment on covenants and terms of the new business relative to what's on the books today?

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

We do, as you imagine in an environment where there's good risk management process, we do period reviews. And we actually just finished a review for the risk teams looking at a couple of the sectors of our portfolio, and we just haven't been subject to structure changes in the segment that we go after in commercial banking or in business banking.

The stuff you read about, the stuff I read about in the United States, it's the far higher end largest syndicated loans made in the United States. That is a different group that you read about things like covenant light, and things like that. That really hasn't made it into the commercial sector, and not into the business banking sector either. So, I would tell you that the changes to structure have been very, very modest in the piece of the business that I'm responsible for.

Mario Mendonca - *TD Securities - Analyst*

That's clear. Thank you.

Operator

Sohrab Movahedi, BMO Capital Markets.

Sohrab Movahedi - *BMO Capital Markets - Analyst*

Hello there. Just a couple of questions. And just on that last one with Mark, maybe, Surjit, the three or so I think you said commercial accounts in the US P&C that drove the PCLs up quarter-on-quarter, what was the year of origination for those accounts?

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

Off hand I do not know, but they were not very recent.

Sohrab Movahedi - *BMO Capital Markets - Analyst*

So they're not reflective of more recent lending standards?

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

No. And really from two accounts, I can't draw many conclusions. In the commercial area, you will generally have a few accounts that contribute to them. And unless you see a pattern with a lot of smaller losses, it's difficult to make an assessment. This is just the normal variability that you see in commercial.

There's nothing out of the portfolio characteristics that I can point to and say, Look, I should be more concerned about that portfolio." I think Mark makes a good point. That the portfolio that he has in commercial is very well diversified with small holds in a very large number of accounts, and very well diversified across industry groups, and the leverage is not very high in them too. So, I'm very comfortable with that portfolio.

Sohrab Movahedi - *BMO Capital Markets - Analyst*

Okay. And then, Mark, just to clarify maybe coming at the US just a little bit differently. If I think of this concept of pre-tax pre-provision earnings, Q2 2012 the US in native currency was $262 million, Q2 2013, it was $258 million, Q2 2014 is $240 million. Where do you think that will trough?

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

So let's maybe go at this a little differently, and see if I can help. I think you're going to see year-over-year earnings growth. I think we'll have maybe some kind of bounce around in pre-tax pre-provision earnings a little bit, but I think we're going to see year-over-year net earnings growth.

As I gave a little bit of an indication of we see some tempering in that in terms of what's going on with net interest margin, albeit, it depends a little bit on the quarters of really strong loan growth. But looking prospectively, feel pretty good about where net earnings are going on a year-over-year basis. Is that a way to go at answering that?

Sohrab Movahedi - *BMO Capital Markets - Analyst*

I think it helps for sure, but it almost feels like the bottom line, which has been right around $150 million to $160 million has basically been driven through that credit cost line. So I'm just trying to get a sense of when does the above-the-line start contributing to the bottom line?

Mark Furlong - BMO Financial Group - Group Head, US P&C Banking

Fair question. And that's the sustained loan growth, as you saw, the run off portfolios are becoming relatively immaterial at this point in time. Margin is beginning to stabilize, and we feel pretty positive about top-line growth looking prospectively from this quarter on.

Sohrab Movahedi - *BMO Capital Markets - Analyst*

Okay. So can I just ask one last question then, I promise it will be the last one. When you think about the US franchise, and if you think about it from a profitability perspective, what will winning look like?

Bill Downe - *BMO Financial Group - CEO*

Maybe, Sohrab, since Mark has had the opportunity to answer two of your questions, I'll go for the third. There is no question that the commercial banking business that we have in the United States is demonstrating traction in a way that we're very satisfied with, and we think that, as Mark said, with the run off disappearing, it's going to be more clear the value of the business that we have.

But the bank is in a fundamentally different position today than we were prior to the recession, in that we now have a very large retail branch system. And there is no question that we're in a historically low interest rate environment. The five-year Treasury rate still reflects a level far below the average, and you can take any period of whether it's 50 years or 30 years or in the last 10 years. So I think everybody gets a lift when administered rates rise, which they inevitably will and some inflation shows up.

But we have 700 bank branches, and that's more than twice what we had not too many years ago. But more importantly, we've invested much more heavily in the brand in the last three years than the rate of investment previously. And there's a lot of operating leverage in the retail bank, and I think that the definition of success is that we continue to be market leaders, as we have been in commercial banking in Canada and the US.

There's no reason why, within our concentrated footprint, we wouldn't be the number one or number two commercial lender. And when the economics of retail banking improve marginally, we get some reasonable economic growth, the strength of our brand, the value of that core deposit base I think is going to be very evident.

And so, I think we are relatively patient around the recovery in interest rates and a period of stronger economic growth. Many of the provisions of Dodd Frank that were very hard on banks that had benefited from some of the things that Dodd Frank squeezed out, we weren't susceptible to. We didn't have very many areas where we had to make adjustments, because we had really built our brands both in the acquired footprint and the legacy footprint around the best interest of the customer.

And I think you're going to see the value of a concentrated footprint in a very healthy market over the next three to five years, and some quite surprising operating leverage in the business. And for us, I think that would be the definition of success.

Sohrab Movahedi - *BMO Capital Markets - Analyst*

Okay. Thank you.

Bill Downe - *BMO Financial Group - CEO*

You're welcome.

Operator

This will conclude today's question-and-answer session. I would now like to turn the meeting back over to Ms. Haward-Laird.

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

Thank you, everyone, for joining us today. If you have any follow-up questions, we'll be happy to help you in Investor Relations. Thanks, and have a great afternoon.