BMO Financial Group

Q2 2018 Conference Call

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PRESENTATION

Jill Homenuk ***Bank of Montreal - Head of Investor, Media & Government Relations***

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 Darryl White, 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 question-and-answer period where we will take questions from prequalified analysts. We have with us today Cam Fowler from Canadian P&C and Dave Casper from U.S. P&C. Pat Cronin is here for BMO Capital Markets; and Joanna Rotenberg is representing BMO 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 assess its performance on a reported and adjusted basis and considers both to be useful in assessing underlying business performance.

Darryl and Tom will be referring to adjusted results in the remarks, unless otherwise noted, as reported. 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 Darryl.

Darryl White ***Bank of Montreal - CEO***

Thank you, Jill, and good afternoon everyone.

The financial results we released today demonstrate our ongoing execution against the strategic priorities we've been communicating, building on our core strengths to deliver accelerated growth today and for the future.

Net income for the second quarter of $1.5 billion grew 13% from last year, and earnings per share of $2.20 were up 15%. There are 2 key underlying drivers to the earnings growth we would like to highlight, both consistent with our expectations. First, we delivered very strong bank-wide operating leverage of 3.5%. And second, our U.S. segment continues to grow faster than the rest of the bank.

And so at the midpoint of the year, we are on track to deliver the financial targets we set out in December.

Our efficiency ratio continues to improve. The restructuring charge we took this quarter accelerates the ongoing bank-wide initiative to transform how we work, how we compete and how we create value for our customers. We're continuing to invest in our technology agenda, focused on automating processes and engaging more customers through personalized digital capabilities.

There is ample evidence that these investments are already paying off. Over 25% of Canadian retail sales are originated via digital channels, and nearly 40% of credit card sales are originated digitally, making us a market leader in this area.

There's no doubt that the bank is becoming leaner, faster and even more unified in our commitment to customer experience. And in many ways, we're just getting started.

Our capital position remains strong with a CET1 ratio of 11.3% after repurchasing 5 million shares this quarter. Today, we announced a $0.03 increase to our quarterly dividend to $0.96 per share, which is up 7% year-over-year. The bank's return on equity improved to 14.9%, in line with our medium-term target.

Driving these results was strong double-digit pre-provision and pre-tax earnings growth and positive operating leverage across each of our U.S. P&C, Canadian P&C and Wealth Management businesses, building on the momentum that we saw last quarter.

The bank's overall revenue growth was well diversified, with good contribution across Personal and Commercial Banking products and wealth business lines. Capital Markets revenue was softer this quarter, primarily reflecting lower client activity in investment banking compared to a particularly strong activity level last year.

Our U.S. segment overall, which is a key differentiator and a strategic focus for us, is delivering strong results, in line with our expectations. Year-to-date earnings from the U.S. are up 28%, increasing the U.S.'s contribution to the overall bank to 27%.

And we've positioned our businesses to take advantage of opportunities to grow in the U.S. Earlier this month, we announced plans to acquire KGS-Alpha Capital Markets, a New York-based fixed income broker-dealer that complements and diversifies our U.S. Capital Markets strategy.

Commercial Banking has always been a core focus and a core strength for us in the U.S. and in Canada. Our commercial bankers are recognized for their expertise and their client focus. Through varying cycles and market dynamics, we remain committed to our customers and to building new relationships so that we're always in the best position to grow with them.

This customer-focused approach has led to strong commercial loan growth, which this quarter was up 10% for both Canadian and U.S. P&C, as well as good growth in commercial deposits where we're providing more clients with integrated treasury and payment solutions.

And with an increasing number of companies in both Canada and the United States doing business on both sides of the border, our experience, expertise and deep relationships uniquely position us to provide expert financial advice to navigate through a dynamic environment.

On October 24, we will be hosting an all-bank Investor Day in Toronto where we'll provide further updates on our strategies and progress in the areas we're focused on; continuing to grow the contribution from our U.S. operations, improving efficiency, investing in our digital innovation agenda and deepening customer loyalty. With our team of highly engaged employees, we're transforming the bank. In doing so, we're holding true to our core values, operating with the highest ethical standards, including honesty and respect for one another, our customers and our communities.

Surjit will be providing an update in his remarks on the customer data incident that occurred earlier this week. I want our customers to know that we take any attack on us and on them extremely seriously. We're reaching out personally to all of those impacted and taking all available means to protect their accounts. Protection of customer privacy is of utmost importance to us.

I'll now turn it over to Tom to review the quarter's results.

Thomas E. Flynn ***Bank of Montreal - CFO***
Thank you, Darryl.

My comments will start on Slide 8. Q2 reported EPS was $1.86, and net income was $1.2 billion. Adjusted EPS was $2.20, up 15% from last year, and adjusted net income was $1.5 billion, up 13%.

Our strong performance reflects momentum across P&C businesses in Canada and the U.S. and a good contribution from Wealth Management.

As shown on Slide 24, adjusting items this quarter include a restructuring charge of $192 million after-tax, primarily for severance. The charge reflects an ongoing bank-wide initiative to simplify how we work and drive increased efficiency while we continue to invest in technology to move our business forward. We expect to generate expense savings of approximately $185 million from the charge.

I'll now turn to the quarterly results and start on Slide 8. Net revenue of $5.3 billion was up 5% from last year or 7%, excluding the impact of the weaker U.S. dollar. Revenue growth was good across our P&C and wealth businesses.

Net interest income increased 3% from last year, and net non-interest revenue was up 6%, with increases across most revenue categories.

Expenses were well managed, up 2%, or 3% excluding the impact of the weaker U.S. dollar, with higher technology investments as the largest single contributor to the increase. We remain focused on improving efficiency while continuing to invest in the business.

Consistent with our expectations, operating leverage was strong in the quarter at 3.5%, reflecting good revenue growth and expense management.

The adjusted effective tax rate was 21% compared to a relatively low rate of 17% last year. The adjusted effective tax rate on a teb basis was 24% compared to 27% a year ago.

Moving to Slide 9. The Common Equity Tier 1 ratio was 11.3%, up approximately 20 basis points from Q1. As shown on the slide, the elimination of the Basel I floor and higher retained earnings was partially offset by higher risk-weighted assets, which was largely a reflection of good business growth, and the repurchase of 5 million common shares in the quarter. Over the past 4 quarters, we have repurchased a total of 13 million shares, and with our dividends, returned approximately 65% of adjusted net income to shareholders.

Moving now to our operating groups and starting on Slide 10. Canadian P&C had good revenue growth and positive operating leverage with adjusted net income of $591 million, up 11%.

Revenue was up 8%, driven by increased non-interest revenue and higher balances and higher margins.

Total loans were up 4%. Personal loan growth was 1%, reflecting participation choices that we've made. Year-over-year mortgage growth through our proprietary channels was similar to the previous quarter and up 4%. We have good momentum in our commercial business, with loans up 10%.

Total deposits increased 4%, with personal deposits up 2%, including 8% growth in chequing account balances. Commercial deposit growth was strong at 9%.

NIM was down 1 basis point from last quarter, primarily due to loans growing faster than deposits. Operating leverage was positive 2.4%, with expenses up 5%, largely reflecting higher technology investments.

The total provision for credit losses was $128 million, with provisions on impaired loans up $10 million.

Moving to U.S. P&C on Slide 11. Adjusted net income was $359 million. The comments that follow speak to the U.S. dollar performance.

Adjusted net income of $280 million was up 50% from last year. Pre-provision, pre-tax earnings growth was very strong as well at 22%. Results reflect continued momentum in the business, a good operating environment, a focus on operating leverage and the benefit of higher interest rates and lower taxes.

Revenue growth was strong at 10% and reflects higher deposit revenue and good commercial loan growth.

Average loan balances increased 10%, with continued leading commercial loan growth of 10%. Personal loan growth reflects the purchase of a mortgage portfolio in the first quarter. Our focus on deposits contributed to 7% deposit growth, including 6% for personal and 8% for commercial.

Net interest margin was up 7 basis points from last quarter, driven by improved deposit revenue and higher interest recoveries, partially offset by changes in business mix.

Expenses were up 3% year-over-year, and operating leverage was strong. Total provisions for credit losses were $42 million with provisions on impaired loans down $16 million.

Turning to Slide 12. BMO Capital Markets adjusted net income was $286 million.

Revenue of $1 billion was 12% lower. Trading Products revenue was down, primarily reflecting lower equity trading revenue. Investment and corporate banking revenue was off from a strong performance last year.

Expenses were 2% lower than last year.

The current quarter had credit recoveries compared to credit losses in the prior year.

Moving to Slide 13. Wealth Management adjusted net income was $307 million, up 12%. Earnings in Traditional Wealth of $238 million were up 18% from last year, driven by good growth across our diversified business. Insurance net income of $69 million was relatively in line with last year.

Expenses increased 6%, mainly due to a higher revenue-based costs and technology investments. Operating leverage was 1.3%.

Turning now to Slide 14 for corporate. The adjusted net loss was $80 million, in line with $74 million a year ago with lower revenue, excluding teb, largely offset by lower expenses.

To conclude, results this quarter reflect continued momentum in our business and demonstrate the benefits of our diversified business mix. Consistent with our comments on our last 2 earnings calls, we expect this momentum to continue in the second half, and we remain focused on achieving our financial targets for the year.

And with that, I'll hand it over to Surjit.

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
Thank you, Tom, and good afternoon, everyone.

Starting on Slide 16. The total provision for credit losses was $160 million or 17 basis points comprised of a provision for credit losses on impaired loans of $172 million and a $12 million reduction in allowances on performing loans.

In Canadian P&C, the increase in PCL on impaired consumer loans was largely because of a one-time collective assessment adjustment for the non-RESL loans. A portion of the increase was also because of higher delinquencies and losses experienced in this segment of the portfolio. The Canadian consumer loss rate on a year-to-date basis better reflects the underlying performance.

PCL on impaired loans for U.S. P&C were down in both consumer and commercial portfolios. This quarter, we recorded large recoveries as a result of our strong resolution capabilities, recoveries of $16 million in Capital Markets and $10 million in Corporate Services. The $12 million reduction in our allowances on performing loans was mainly due to an improved economic outlook benefiting U.S. P&C.

Turning to the next slide. Gross impaired loans are largely flat quarter-over-quarter. The GIL ratio decreased 1 basis point to 56 basis points.

On Slide 18, delinquency and loss rates for the Canadian residential mortgage portfolio remained stable this quarter.

Overall, we had another strong quarter from a credit perspective. Given the benign economic environment, I expect continued good performance.

Now on the topic of the recent cyber incident. As Darryl said, we are focused on our customers, and we support and stand by them. From a risk perspective, we are now in an increasingly digital age that brings benefits to our customers but also new challenges for industries like ours. Within this changing landscape, information and cyber security has been an ongoing priority for some time and shall remain so. We will continue to enhance our layered defenses, and learnings from incidents like this only strengthen us and our industry. Our commitment to customer privacy and security is unflinching.

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

QUESTIONS AND ANSWERS

Meny Grauman ***Cormark Securities Inc.***
We saw a recent M&A transaction in the Chicago area. I'm just wondering your thoughts on competitive dynamics and valuation in the context of that deal.

Darryl White ***Bank of Montreal - CEO***
Meny, it's Darryl. And given that you referenced Chicago, I might ask Dave to comment. Thanks for the question. We have a business that we feel pretty good about in the Chicago market to start with, and we're feeling increasingly good about that business from a competitive position, to answer your question. We don't naturally comment on any particular transaction. We congratulate the parties that were involved in that transaction, but we can't comment any further. And our strategy, I would say, remains completely unchanged, and I'm very comfortable with the position that we've got in the market and the advantages that we have in that market in particular. Dave, did you want to add to that?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
Sure, Meny. I would say Chicago is our home market. It's our U.S. headquarters. It's a big market for us -- we're #2 in deposits, and we are #2 in our commercial business. And just as a perspective, about 10 years ago, we were #4 in commercial. So we've gone from #4 to #3 to #2. And all of those -- every time we've won one of those clients, none of those commercial clients has been as a result of a merger. The last merger we did that would have impacted of our commercial business was when BMO bought Harris Bank in 1984. So it's a competitive market. It always has been. And I think the fact that we've moved to the market share we have is probably a good indication of how we feel about competing going forward.

Meny Grauman Cormark Securities Inc.
Would you be able to comment just in general on your outlook for -- or your view of valuations in the Midwest and specifically, are they improving or deteriorating and how you view them?

Darryl White ***Bank of Montreal - CEO***
It depends on the circumstance. I don't think that you can make a sweeping comment with respect to valuations in the Midwest, frankly, or anywhere. And in our case, we're not so worried about valuations generally as we are, under particular circumstances, I've said it before, I'll say it again, we look at financial fit, cultural fit and strategic fit, and we're very disciplined about how we look at that. If something happens to work, then great. But if not, we're not worried about general valuation trends. Does that help?

Meny Grauman Cormark Securities Inc.
Yes. And then just a quick numbers question in terms of the restructuring. Could you just talk about the split between Canada and the U.S. on that?

Thomas E. Flynn ***Bank of Montreal - CFO***
It's Tom. I'll take that question. I'd say a couple of things. Number one, it was a bank-wide charge, and so with that, the distribution across business groups, functions and geographies is fairly representative of the business that we've got. So the U.S. would be roughly in line with the proportion of the bank it represents in terms of its participation in the charge.

Robert Sedran ***CIBC Capital Markets***
Surjit, we probably were expecting some volatility on IFRS 9, but probably not a marked step-down in the run-rate on PCLs on impaired, which we've seen so far this year. You noted that recoveries are part of it. So what kind of visibility do you have on recoveries as we start to think about the next few quarters? Would you expect to come back to a more normal level? Or do you have a decent pipeline of these recoveries coming back? And wondering what a corporate recovery might be.

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
Well, recoveries, again, like commercial and corporate PCLs, are a bit lumpy. Having said that, I think we have seen, at this point in the cycle, the vast majority of the recoveries already coming through. So it's now late in the cycle, so recoveries will reduce. So the guidance I would give you in terms of the PCLs or in terms of an outlook, given the benign environment that we all refer to, will be in the low to mid 20s for us.

Robert Sedran ***CIBC Capital Markets***
Okay. And Tom, just a follow-up on that restructuring charge question. The savings outlook you gave, was that a pre-tax or post-tax number?

Thomas E. Flynn ***Bank of Montreal - CFO***
That's a pre-tax number. So $185 million pre-tax.

Robert Sedran ***CIBC Capital Markets***
Can you help us understand what's the relatively sizable difference between the charge and the savings? I know it's not all severance, but just wondering what the difference is between the two.

Thomas E. Flynn ***Bank of Montreal - CFO***
Yes. It's not all severance, although the strong majority of the charge is severance. And I would say the relationship between the severance and the savings can vary depending on the charge. And it's a little lower here, not totally out of line with what we've seen before. And that really just reflects the mix of individuals impacted. Nothing more than that, I would say.

Robert Sedran ***CIBC Capital Markets***
Okay. And you've had one in each of the last 4 years. Is it safe to assume that as the bank continues to reorient itself to a more digital future that we should probably plan for another one this year? Or do you think this one holds you for a while?

Thomas E. Flynn ***Bank of Montreal - CFO***
Well, I won't comment specifically on the future, but what I would say is we are, as a bank and as an industry, going through a period of accelerated change. We are front-footed as we participate in that. And the charges enable us to keep going at the pace that we would like to, and that pace is likely to continue for some period of time but not forever at the same time.

Ebrahim Poonawala ***BofA Merrill Lynch***
I just wanted to follow up in terms of the operating leverage. When I look at the efficiency ratio that you break down in the supplement on Page 2, first half last year averaged about 63%. It's similar again this year at 63%. Can we talk about your outlook in terms of positive operating leverage and how that sustainably translates into a lower efficiency ratio? I'm just trying to understand, does that number fall below 60% at some point and stay there and maybe go lower from there? Any colour you can provide would be helpful.

Thomas E. Flynn ***Bank of Montreal - CFO***
It's Tom. I'll take that. A few things. Number one, the mid-term financial target we have that's related to operating leverage and efficiency, as you know, is the 2% target. We've hit that for the last 2 years. And with that, our efficiency ratio was down by, I think, it's 240 basis points over the last 2 years. And we're focused on hitting the 2% operating leverage target this year as well. And so I would expect as we hit the operating leverage target for the efficiency ratio to trend down as it has been trending down through time. The numbers can move around in any quarter, but the trend, I think, has been pretty clear when you look at the adjusted efficiency net of CCPB, which is the true operating number.

Ebrahim Poonawala ***BofA Merrill Lynch***
Right, which was 61.8 in the second quarter.

Thomas E. Flynn ***Bank of Montreal - CFO***
Yes.

Ebrahim Poonawala ***BofA Merrill Lynch***
Right. And any sense, Tom, like when that could actually sustainably fall below 60%?

Thomas E. Flynn ***Bank of Montreal - CFO***
I guess, what I'd say is over the last couple of years, we're down by over 200 basis points. And if you take that amount off of where we are now, we're bumping into the 60%, and we are focused on doing the same things over the next few years that we've done over the last two on the ratio.

Ebrahim Poonawala ***BofA Merrill Lynch***
Understood. And I guess, on a separate question for Darryl. On Slide 6, you mentioned the U.S. segment as a key area of strategic focus. I think outside of any M&A, could you talk about in terms of what you're doing in the U.S. in terms of investments on the business side, new markets on the consumer side?

Darryl White ***Bank of Montreal - CEO***
Well, thanks, Ebrahim. New investments is probably not the way we're thinking about it right now. We're always making new investments in the businesses where we've chosen to participate. What you're seeing is an acceleration of the performance of those businesses as a result of the investments that we're making. So if you think about the footprint that we've got, I mentioned in my remarks that we're now around 27% of our total bank is in the United States, and that segment is growing faster than the rest of the bank. If you look at the composition of the performance in those businesses, it's in our P&C business, it's in our capital markets business and it's in our wealth business. In each case, we haven't strayed from the strategy. We haven't put out new markers in terms of an extension of that strategy. But we've deepened the focus of the customers within that strategy, and we've delivered the leverage that we're talking about. In the meantime, we extend that strategy by offering new products, new businesses, hiring bankers. But you should see this as delivering what we set out to do as opposed to making new strategic strides.

Sumit Malhotra ***Scotiabank***
I want to start with Dave Casper, please. First on your commercial loan growth in the U.S. Looking at the industry data through April. It seems like there's been some signs of acceleration, though the overall numbers for the industry as a whole are still pretty muted on a year-over-year basis. What do you think has been the differentiator for BMO? I look at the year-over-year numbers because I know things can jump around in the quarters. But you're back up to a double-digit pace of growth, which, quick math, is something like 3x the industry average. What do you think it is about your book of business that's allowed BMO to have faster commercial loan growth in the U.S. than what we've seen with peers?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
Well, it's a couple of things. First, in our markets that we've been in for a long period of time, we have consistently gained market share there. I think we are viewed as a strong competitor that has seen all the cycles, and that market share has really increased since 2009 and 2010 when we really thought this was a commercial-led recovery, and we've pushed -- and we've consistently pushed to grow with the companies we want to grow with. But secondly, and I think equally importantly, there are a number of our businesses that prior to M&I, when we purchased M&I in 2011, we really didn't have national businesses. So that would be our equipment finance business, our asset-based lending business, our dealer finance business and certainly the acquisition of Transportation Finance. All those businesses are still not where we want them to be as far as there's a lot more growth that we can take there, and I think those 2 areas would be the primary reason.

Sumit Malhotra ***Scotiabank***
And how does that tie into margin? I mean, it feels like -- not even feels like, but we see it in the supplement. Your margin had a flatter trend over the past year. And even if I go back 3 months ago to the call, it didn't sound like you were that bullish on the prospects for meaningful NIM expansion from where we were. We saw a decent sized increase this quarter. Anything specific or one-offish that helped that number? Or is this the uptick in the loan growth that's really pushed margin higher?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
No, I think the primary reason for the margin is the rate increase. And because of the way we're set up, that's a positive, and that accounted for substantially all of the margin increase. And there's a couple of things that would have helped us well this quarter. We had some interest recoveries that probably was a couple of basis points. The spreads on the loans would be a negative offset to the extent that there are any, and there was a little bit of that. It is competitive out there. We'd rather compete on price than structure. But overall, the competitive pressure on the loans side has not been as significant as, I think, some of our peers, and I think it's just -- we hope that continues. Does that help answer the question?

Sumit Malhotra ***Scotiabank***
That's helpful. And I'm going to wrap up with one for Darryl. I'm sure the capital deployment question is one that comes up for all relatively new CEOs, and maybe the acquisition that we saw a couple of weeks ago has amplified that. The way I'd phrase it to you, Darryl, is some of your counterparts who have been introduced in the last few years have spent some time perhaps looking at the operational performance of their institution before looking to add on via M&A. Maybe a broader question, and on the day that you announced the restructuring charge, I think it's one that's important to us. Do you feel that the bank is well positioned to consider M&A from an operating perspective now? Or are there other capital deployment or operating boxes you'd like to tick, so to speak, before the acquisition opportunity moves more to the forefront?

Darryl White ***Bank of Montreal - CEO***
Thanks for the question, Sumit. The short answer is yes. Are we well positioned for the right event at the right price and the right strategic fit and the cultural fit? Yes. If what you're getting at is do we have to do a lot of things operationally before we could turn our attention to something like that, if it'd check those boxes, the answer is no. We're prepared. But I would point out that you can't always control the timing of these things, and you certainly can't control making everything fit into the mold that I just described. So in the meantime, we're always trying to maintain the balance to preserve that strategic flexibility, that tactical flexibility that you're asking about with the return of capital to shareholders and the investment in the existing businesses. So we're continuing to do that. If the right thing were available, we would be prepared. Is that helpful?

Sumit Malhotra ***Scotiabank***
That's helpful. And maybe since you've phrased it that way, I'll just ask -- this is the last part of it, I promise. So your mix of business in the U.S., specifically in the P&C bank, is skewed more towards loans than deposits. And this just looking at your P&C business in the U.S., the last

transaction that BMO is involved in kind of a major way was the GE transportation finance, which was obviously more in the lending side. What would be on your wish list, so to speak, in terms of what kind of capabilities you'd be looking to add? Is the focus more on deposits now, given that change in skew? Or is there something different that you'd be thinking about?

Darryl White ***Bank of Montreal - CEO***
No, I would reorient your question a little bit, Sumit. We're not on the hunt in general, I would say. First of all, we're not on the hunt. Secondly, I would say, we're not on a hunt in particular for loans versus deposits. We're in the business of looking at good businesses that serve customer segments. And most of the businesses you look at have a balance of loan and deposits that makes sense, and when you put it on the context of our entire bank doesn't really turn the dial. So we don't really think about it as looking for a loan or looking for a deposit, but if it fits the other criteria that I'm talking about, we'd then have a hard look.

Gabriel Dechaine ***National Bank Financial, Inc.***
Just a quickie on the U.S., and then I`ve got a restructuring-related one. On the U.S., Sumit was asking about the loans there. I'm curious about the deposits, and where you're seeing stronger growth in commercial deposit rates. But we're hearing more and more about the betas and more pass-through to customers. How is that affecting your margin outlook, the heightened competitive market for deposits in commercial?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
Well, you're right. As you would expect, the betas in the commercial side are higher. We don't pass everything on in the commercial side. But as you go through the spectrum, that would be higher at that end than at the retail side. I expect that we'll continue to be competitive, but certainly, meet the market but not beat it. I think we still have -- with rate increases, it's still positive for us, net what we give back to our commercial clients. We also, as you know, we have a big treasury management business in the U.S. as we do in Canada in commercial, and a lot of those pay fees as opposed to deposits, so it's not as impacted.

Gabriel Dechaine ***National Bank Financial, Inc.***
That's included in the $45.1 million I guess?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
Yes, well, to the extent that they pay for it in deposits, yes.

Gabriel Dechaine ***National Bank Financial, Inc.***
Okay. So can you put a perspective on your margin outlook like a year ago?

Dave Casper ***BMO Harris Bank President & CEO, Group Head Commercial Banking***
I would say that going forward, if you're really looking at the NIM, I would say, to the extent that we do have the rate increase that we would expect in June, that will be positive for us, and net-net, that would be positive to our NIM. The things, though, that you always have to always keep in mind though, loan growth will have an impact. Interest recoveries we'll be having in any one quarter would have a bit of an impact. But we don't think that -- we don't see any real negatives coming forward on the NIM side in the near term. Does that help?

Gabriel Dechaine ***National Bank Financial, Inc.***
Directionally, yes, that's helpful. Then on the restructuring side of things, just wondering if you learned anything from the last experience because in my experience investors get a bit excited about these charges because you might expect a burst of operating leverage shortly thereafter. But if I look at your 2015, 2016 period of restructuring, you had a very strong run of operating leverage post restructuring charges, and then it tailed off quite substantially in 2017. Are you going to manage it differently this time? I know there's other factors, revenue trends and all that stuff, but I'm wondering if there's any underlying strategy there that might have changed.

Thomas E. Flynn ***Bank of Montreal - CFO***
It's Tom. I can start with that question. I would say, you always live and learn. Our operating leverage for the last 2 years, as we've said before, has hit the mid-term target. So we hit 2% in '16. We hit 2% in '17. We're focused on doing the same in '18. And the charge allows us to move our business forward by investing more in technology to adjust to the changing nature of work, in places to simplify the organizational structure and in places to realign resources where market opportunities have shifted one way or another. And we believe we've got a good ability to execute and a good capability that has been built up over time. And it's a dynamic thing. And so the charge does result in lower expenses in parts of the organization. We see those dollars come through without doubt, and we're investing in technology at the same time. And in the last couple of years, the technology spend has grown at a double-digit rate, while the overall rate of expense growth has been, on an adjusted basis constant currency, about 4%, and we hit the operating leverage target. So we're trying to juggle all of those things at the same time, and I would say I feel good about the progress that we've had on the operating leverage side.

Gabriel Dechaine ***National Bank Financial, Inc.***
When you say live and learn, was there something that you can point to?

Thomas E. Flynn ***Bank of Montreal - CFO***
I would say nothing more than I spoke to. That was, as a general comment, being responsive to the nature of your question, but the rest of my answer stands.

Doug Young ***Desjardins Securities Inc.***
I guess, first question, Tom, if I look at your Slide 9, and I just look at the continuity of CET1, and I think your internal capital generation, 22 basis points. I add back the impact of the restructuring charge, and then I look at the risk-weighted asset inflation at 33 basis points, excluding all the other kind of noise, it looks, from an organic perspective, that your CET1 is down. And I'm just trying to gauge as to -- and I know you had the Basel I floor come out and possibly utilized that to fund good commercial loan growth. I'm just trying to get a sense of, as we look forward over the next few years, has there something changed in terms of the way BMO will accrete CET1? Is it still 15, 20 basis points per quarter? Or as we get a shift and pivot in faster growth in commercial or more opportunities in Capital Markets, to put capital to work, has that internal net capital CET1 generation changed?'

Thomas E. Flynn ***Bank of Montreal - CFO***
Okay, thanks for the question. The short answer, which I'll elaborate on, is that we don't see anything as having changed. Take your points that in the quarter, the net capital generation was lower than we've been running at. And there, like you did in your question, I'd say you need to incorporate the elimination of the Basel I floor and the share repurchases. And when you look at the core performance, RWA was up in the quarter, and that reflected 2 things: number one, very good commercial loan growth across our businesses, 10% in both Canada and in the U.S. And then as well, we did have some model-related changes to the RWA in credit risk, operational risk and market risk. None individually big, but in total, they added in the zone of $2 billion to RWA. So that was part of the story for the quarter. And then from an outlook perspective, over the last few years, we've tried to say 2 things. Number one the general expectation is that the accretion to the ratio will be, before considering buybacks, at the rate of 10 to 15 basis points per quarter. And then secondly, it does move around quarter-to-quarter. And sometimes it's a little higher, sometimes it's a little lower. But our expectation sitting here today is really the same at the 10 to 15 basis point level.

Doug Young ***Desjardins Securities Inc.***
And just to follow up on the model refinement. Is there any big item that occurred in the review of any particular book in the quarter?

Thomas E. Flynn ***Bank of Montreal - CFO***
Nothing big. And they were model-related. So for example, in Canadian P&C, I think it was consumer. We had a PD, or probability of default, recalibration. In operational risk, we look at industry-wide operational risk events. There was a loss somewhere in the industry that bumped up some of our parameters a little bit, not significantly. And then in market risk, we incorporated higher levels of market volatility, which inflated the RWA a little bit, and that flows through the model. So nothing individually big, but the collection of things did contribute to the RWA growth in the quarter.

Doug Young ***Desjardins Securities Inc.***
And anything on the horizon in terms of reviews of books that you see over the next year or so?

Thomas E. Flynn ***Bank of Montreal - CFO***
No. There's ongoing regular reviews, but nothing of a lumpy nature that would result from our internal reviews. There are a couple of new capital regulatory standards that are coming in likely in Q1 of next year. So these are, again, not the result of any work we're doing. They're industry changes. They have not yet been finalized. But it’s possible that we’ll have counterparty credit risk and securitization changes to risk-weighted assets in Q1 of next year. And those changes, if they come through, would have some impact on RWA. Not huge, but some impact.

Doug Young ***Desjardins Securities Inc.***
Okay. And then just second, you had a credit recovery in corporate. I'm just curious as to what that relates to. Is there a business in there that I wasn't aware of? And if you can just flush that out, that would be helpful.

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
Yes, this is Surjit. I'll address that. If you recall, we had a purchased credit impaired book when we bought M&I. And this is just a residual part of what was left. There's a little recovery there that's in corporate.

Doug Young ***Desjardins Securities Inc.***
Okay. And is that done essentially? Or is it...

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
Well, the portfolio is really small. I think it's about $150 million carrying value right now. So it's quite small now.

Stephen Theriault ***Eight Capital***
A couple of things from me. And maybe starting with Tom since we're on it and just to extend Doug's question a little, appreciating the colour from his comments. But when I look through, it's really 3 of the last 4 quarters the internal capital generation has been either offset or more than offset by higher source currency RWA. And I hear you that 10 to 15 basis points holds. I don't know if that's through the cycle commentary, but is there anything going on right now? Is it the stronger commercial growth in Canada, the resilient C&I? Maybe just a little more detail it on what -- it sounds like it's more than a 1-quarter impact, so wondering if you have anything else you can give us on that.

Thomas E. Flynn ***Bank of Montreal - CFO***
I guess a few things. The commercial loan growth was very good in the quarter. It's been running at the upper single-digit or low double-digit rate for the last year. And we have been active with the buyback. I think you're looking through that, but over the last 4 quarters, we've bought back 2% of the outstanding stock. That has helped with the EPS accretion, which you saw in the quarter. It has had an impact on the ratio of about 40 or 45 basis points. And the ratio, obviously, continues to be strong. And the Basel I floor, as you know, was a little more RWA intensive for some portfolios. That is an issue we don't have anymore. But for some portfolios, including commercial, it was more RWA intensive, given its risk and sensitivity.

Stephen Theriault ***Eight Capital***
And then Basel II floor, you mentioned, I think you told me last quarter that could kick in next year. Could that be anything meaningful to excess capital generation?

Thomas E. Flynn ***Bank of Montreal - CFO***
We don't expect it to be. We've got a decent sized cushion, to use that word. At present, there's some potential for the floor to kick in next year. But I'd say, sitting here, I wouldn't expect the guidance that we would give around accretion to change if it did kick in.

Stephen Theriault ***Eight Capital***
Okay. And second for Pat, if I could. Everybody's had some softer numbers, but looking at operating leverage, the operating leverage for Capital Markets has been negative pretty close to the double-digit the last 4 quarters. Not that your peers have been positive. But is there any frustration regarding the stickiness of the expense line? Anything in the works to add more flexibility to the expense line? Or is it just the reality of a softer capital markets environment that we need to work through?

Patrick Cronin ***BMO Capital Markets Corp. - CEO***
Yes. I would say it's very much a revenue story, and it's pretty tough when you have a really good Q2 of last year, particularly for the investment banking group where it was an all-time record. That operating leverage is going to get affected by that. But there is some validity to your second part of your comment around expenses. They're just stickier to move in the short term. We made all of the adjustments we thought necessary for the things like performance-based compensation and some of the other things. But the larger part of the expense base takes longer to move. If we continue to see this kind of a revenue environment, you should expect us to be much more aggressive on those parts of the expense line. But in the short term, we're much more focused on increasing the revenue part of the profile.

Stephen Theriault ***Eight Capital***
And I guess, some of that's been addressed with the restructuring?

Patrick Cronin ***BMO Capital Markets Corp. - CEO***
That is correct. We would have been a part of the charge for sure. And so you will see some of that over the course of Q3 and Q4 and a full year effect of that. And I think, on the revenue side, I have reasonable optimism as I look at the pipelines for the balance of the year particularly as I look at the underwriting advisory line, I think you've seen across the board, some weakness there. But when I look at our pipelines, whether that be in M&A or in the debt pipelines, particularly in the U.S., it's looking very optimistic for the second half of the year. So market conditions dependent, we think the second half will change that operating leverage picture to some extent.

Mario Mendonca ***TD Securities***
Surjit, could you help me think through the nexus between this accelerated digital transformation and the breach, the data breach? I've always thought of this digital transformation as enhancing operational risk, as in lowering operational risk. But I'm wondering if in fact, I have that reversed. And I'm not referring to BMO specifically. It's in the news all the time, these data breaches. And I'm wondering if, in fact, the accelerated digital transformation is a contributing factor. Can you help me think that through?

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
I think it certainly is. As the technology people will describe it, or the cyber people describe it, as the attack surface increases, so does the vulnerability, and which is why we all, as I mentioned in my remarks, have to keep abreast with all the developments that are happening in the marketplace. And our defenses have to be current. And each event that happens in the marketplace allows us to think though where we are. There will be bad actors that will attack banks or other institutions, be it for disruption of, or for financial gain. And each one is different. And so to that extent, from an operational risk standpoint, I think the risk has gone up. The cost has come down. The cost of delivery and convenience has certainly changed. But from an operational risk standpoint, I think there is an element that has gone up. There's no question about it, and we have

got to be better prepared for it.

Mario Mendonca ***TD Securities***
Now, this data breach, as far as I can tell, it's not a big one. This is not one that should keep everybody awake at night. But the consequences of a very large one are really hard to measure on the credibility, the reputational risk for the bank. At what point do you say this digital transformation is going too fast and the consequences of getting this wrong are too great? Are we anywhere near that threshold?

Surjit S. Rajpal ***Bank of Montreal - Chief Risk Officer***
That's a really difficult thing to answer, but I don't think it's going too fast. I think the technology is there, and it's there to be used in some ways. The question is how well are you managing it, and I think we are doing -- we are all managing it quite well, given the pace at which the change is happening. And so I wouldn't say we will ever reach a point where we'll say this is happening too fast. And it's not just our industry. Whether it is self-driving cars or whether it's digital transformation in the banking area, it's the same thing, it will happen over time but in our space, I think it's going to grow faster.

Mario Mendonca ***TD Securities***
And real quickly, Tom, anything Basel IV related, or the Basel III reforms, depending on how you want to refer to it. When I speak to Canadians, they don't care. When I speak to folks outside of Canada, they really care. So what is your outlook for Basel III reforms or Basel IV, depending on how you look at it?

Thomas E. Flynn ***Bank of Montreal - CFO***
I would say too early to tell. We're expecting to have engagement with OSFI on this. They've said they're going to go through a consultation period. And so it's something that we are paying attention to. We're engaged on it, but it's really too early to tell from an impact perspective.

Darko Mihelic ***RBC Capital Markets***
My questions, I just have 2 of them, revolve around Canadian P&C. And it might be helpful if you look at the supplemental on Page 6. And in particular, the first question revolves around business and government, Line 30, the $68.7 billion average balances. And when I look at that quarter-over-quarter, that's the largest increase. Actually, whether we look at it percentage-wise or dollar terms we've ever seen from Bank of Montreal. And in fact, I just checked against all the banks. It's the biggest we've ever seen in any of them. So first question, is there something specific in this quarter that you changed your classification? Or what would have driven that kind of quarter-over-quarter increase in your commercial lending volumes?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***
It's Cam speaking, and thanks for the question. We haven't changed specifically anything in our posture at all. You all have seen that we had strong growth across the commercial business and quite a strong quarter-over-quarter jump. I'm going to have to come back on that one specifically. But there is no change in posture in that number. Let us come back to you, please.

Darko Mihelic ***RBC Capital Markets***
Okay. And then my other question revolves around the other, which would really be around retail, so from Line 27 down to 29. I mean, in each of those cases, your growth rates are markedly lower than peers and have been for some time. And I got the impression in some of the remarks earlier is that this was somewhat intentional. So the question, Cam, is if it is intentional, how long do you intend to cede share in the personal lines here? And what would need to change your mind? Whether it be economic or what have you, what would change your mind to make you want to go out and grow your market share in mortgages, credit cards and consumer installment?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***
Okay. Thanks for the question. So I do agree with your overarching point, which is that we are very appreciative of the mix we have. We do feel it's an advantaged mix, heavier commercial and slightly lighter in some areas on the personal side. But let's take each of the lines in turn because it's not perfectly instructive to look at them in these categorizations. For example, on the mortgage side, the objective of our strategy in mortgages is not to cede share. It's to be at market or gain share in the channels that we control. So participation in third-party and other such sub-segments of the market are less interesting to us and less valuable to us, proprietary origination higher. Same would be true on indirect auto, where we have pulled back. In cards in recent quarters, we've set our postures forward on that, and we've actually been taking, although modest, been taking share on the retail cards side for the last few quarters. I think it's a momentum game. Our momentum in commercial is as strong as it can be and we're really pleased with that and there are a few areas where, I think, you can expect to see more momentum on the retail side, and for that, I would point to retail deposits with a focus on chequing as opposed to say treasury, and on retail cards. And I expect us to be a little bit stronger in the unsecured lending space in the back half of the year and going into next year. And into next year, I'd expect you'd see more movement on the indirect side as well. So it isn't, putting it altogether, any single thing where we've said we'd like to slow down in retail. It's quite the opposite. There are a couple of areas where we participate less and a couple of areas we're expecting to see share gains in the back half of the year and into next year.

Scott Chan ***Canaccord Genuity***
Sticking maybe with Cam, just on the Canadian side. The product mix seems to be growing faster in commercial, yet your NIM was down sequentially unlike peers in the quarter. Are there other factors that kind of drove that? And how do we think about that for the balance of the year?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***
Thanks for the question. We have good momentum on the NIM. Up 10 points year-on-year, we think it's positive. We're stable on the quarter, as you point out, just down 1 bp at 259 from 260. Maybe one way to think about it is that we enjoyed a basis point last quarter and 5 on the quarter before. We've been taking some of this benefit earlier than others, I would say. And so that's one point. And the second point I would say is I expect us to be up probably in the 2- to 4-point range in the back half of the year on NIM.

Scott Chan ***Canaccord Genuity***
Okay. And maybe just for Tom, just on the expected cost savings. Do you have a time frame that would help us out on that?

Thomas E. Flynn ***Bank of Montreal - CFO***
Yes, sure. So the total that we talked about is $185 million. And we would expect to be at that run-rate a year from now. And it will phase in a little bit front-end loaded over that period of time.

Scott Chan ***Canaccord Genuity***
So from a 1-year period or a 2-year period?

Thomas E. Flynn ***Bank of Montreal - CFO***
One year, yes. So fully there within a year and somewhat front-end loaded, but not radically so.

Darryl White ***Bank of Montreal - CEO***
Well, thanks, operator, and thank you to all of you for your questions. I'll close just with a quick framing comment. Last quarter, I talked about the confidence we have in all of our businesses and the commitment to achieving the financial targets that we spoke to you about. And that confidence continues. As you've heard today, we have momentum in our U.S. P&C business that's driving very strong results. Our Canadian P&C business is delivering good and consistent underlying earnings growth. Wealth Management had one of its strongest quarters. And the outlook, as you heard from Pat, for Capital Markets in the second half of the year, is good. So as a result, we are on track to achieving our operating leverage target, as Tom said, for the third year in a row. The bank's performance this quarter, I believe, is indicative of our potential, and I remain confident that our diversified businesses will deliver sustainable earnings growth for the future.

So thank you to everyone for your time and joining the call today. We look forward to speaking to you again in August and at our Investor Day in October. Thanks, everyone.