BMO Financial Group

Q4 2018 Conference Call

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

PRESENTATION

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

Thank you. Good Morning, 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 Pat Cronin, our Chief Risk Officer.

Following the formal remarks, our Group Head for each of our businesses will provide comments on their outlook for 2019. We have with us today Cam Fowler from Canadian P&C, and Dave Casper from U.S. P&C. Dan Barclay is here for BMO Capital Markets and Joanna Rotenberg is representing BMO Wealth Management.

After the presentations, we will have a question-and-answer period where we will take questions from prequalified analysts. To give everyone an opportunity to participate, please keep it to 1 or 2 questions.

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 measure 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.

Darryl and Tom will be referring to adjusted results in their 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 MD&A and our fourth quarter earnings release. With that said, I will hand things over to Darryl.

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

Thank you, Jill, and good morning, everyone. This morning, we announced earnings for the fourth quarter of $1.5 billion concluding a strong year in which net income increased 9% to $6 billion. Earnings per share for the year of $8.99 were up 10%, benefiting from our diversified and competitively advantaged business mix. Return on equity for the year was 14.6%.

When I think about the key takeaways for the year, we have made good progress against the areas we've been focused on - growing the contribution from our U.S. operations, improving efficiency, while at the same time, investing in our digital innovation agenda and deepening customer loyalty.

In the U.S., our combined businesses have delivered USD 1.3 billion in earnings and are positioned for continued growth.

We have managed the overall rate of expense growth at a consistent rate of 4% in constant currency in each of the last 4 years, while at the same time, increasing our technology spend at a double-digit rate over the last 2 years. We're seeing the benefits of these investments in improved customer loyalty scores, increased digital engagement and a better employee experience through more simplified and automated processes.

We've also maintained a strong capital position, while at the same time, growing our businesses and returning $3.4 billion of capital to our shareholders. During the year, we repurchased 10 million shares and today, we announced an increase to our quarterly dividend of $0.04 per common share or 8%. This will bring our annual dividend to $4 even.

On Slide 5, we provide the results of our overall U.S. segment. Consistent with our stated priorities, net income was up 26% and contributed 28% of the bank's 2018 earnings compared to 24% in 2017. This was led by strong momentum in U.S. P&C across our commercial and personal businesses where our productivity ratio was below 60% for the first time. We have maintained investments in our U.S. capital markets business, which are increasing our client footprint and strengthening our relationships. And in U.S. wealth, we've had a good underlying performance, and we're committed to accelerating profitable growth in the business going forward.

On Slide 6, our strategic priorities remain consistent and have been refocused to address the changing market landscape. At our recent Investor Day, we laid out how we're building on our strong foundation to deliver competitive performance and accelerate growth in priority areas.

The U.S. segment remains a top priority where we'll continue to grow earnings at a faster pace than the overall bank.

We're maintaining our leading position in commercial banking with our unique one-bank cross-border approach. This year, we had double-digit loan growth in both Canada and in United States as well as good deposit growth. The growth is well-diversified across sectors and geographies consistent with our approach to building our business within our risk appetite.

On the personal side, we're also seeing increased momentum in the U.S. where personal deposits were up 7% for the year and personal loans have increased in each of the last 5 quarters. In Canada, we are accelerating personal customer growth through targeted sales force additions and a continued focus on digital sales and engagement.

We're executing against the growth initiatives in our wealth business resulting in good underlying performance for the year. And in Asset Management, we continue to enhance our leading investment in research capabilities including in the critical area of sustainable investing. Recently, our responsible investing team in London was named the best ESG research team of the year at the 2018 Investment Week Sustainable & ESG Investment Awards.

In Insurance, results were below trend reflecting elevated reinsurance claims and unfavourable market movements. As you'll hear from Joanna, we're adjusting our positioning to reduce the variability in our insurance earnings going forward, while continuing to target profitable business growth.

In BMO Capital Markets, earnings for the year declined from a strong performance last year reflecting less constructive market conditions in some of our targeted sectors. The investments that we have made this year, particularly in the U.S., position us for good earnings growth in 2019.

Continuing to invest in technology, innovation and revenue growth initiatives is a key driver of our strategy to deliver sustainable long-term competitive performance. The benefits are evident across the bank as we deliver real value to our customers.

In the United States, nearly 1 million customers will be using our new enhanced digital banking platform within the next couple of months and our new account opening app launched in September is already contributing to new customer and deposit growth.

In Canada, as you know, we've talked about having a leading position in retail digital sales at 25%, which is up 50% from last year and we're continuing to move that higher. For our small business customers, we've introduced a new digital platform with faster loan adjudication, all of which brings more customers to the bank.

At our Investor Day, Luke Seabrook spoke about the launch of our BMO Innovation Fund, an enterprise-wide program that takes employee ideas and turns them into reality to enhance customer experience. These are the types of initiatives that will continue to drive sustainable productivity improvements across the bank.

We have achieved 2% operating leverage in each of the prior 2 years and have exceeded that level in each of the last 3 quarters. This performance has led to an improvement in our efficiency ratio of 330 basis points since 2015. For 2018, adjusted operating leverage was 1.2%, and on an underlying basis, considering only the impact of the reinsurance claims and a legal provision in wealth, operating leverage was, in fact, 1.7%. While not quite at our targeted level, momentum is strong, and we're committed to our medium-term target of 2% or better going forward, and improving our efficiency ratio to 58% over the next 3 years.

Looking ahead, while there's been some volatility in equity markets recently, the economic fundamentals remain strong, and we're leveraging our competitive strengths to grow our businesses. We're actively supporting our customers to promote economic growth. To that end, we've engaged in a pilot project recently announced by the Government of Canada to help connect clients interested in pursuing export opportunities with the key federal government resources available to them to access new markets internationally.

As you'll hear shortly from our business leaders, each of our operating groups is well positioned for continued growth and we feel confident about the future. I'd like to welcome Dan Barclay, Group Head Capital Markets to his first call.

And as you know, Pat Cronin, who has succeeded Surjit Rajpal, as our Chief Risk Officer, will be reviewing our risk performance in a moment. I'd like to officially acknowledge and thank Surjit for his exceptional contributions to the bank over 35 years, and I wish him continued success in retirement.

And now, I'll turn it over to Tom, to talk about the fourth quarter.

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

Thank you, Darryl. My comments will focus on the fourth quarter results and start on Slide 9.

Q4 reported EPS was $2.57 and net income was $1.7 billion. Adjusted EPS was $2.32, up 19% and adjusted net income was $1.5 billion, up 17%.

Adjusting items for this quarter include the positive impact from the remeasurement of an employee benefit liability of $203 million after tax, as a result of changes to benefit plans. In addition to this one-time gain, the changes made will reduce our operating costs going forward. Other adjusting items are similar in character to past quarters and are shown on Slide 26.

Turning now to the quarterly results in more detail. Net revenue of $5.5 billion was up 9% or 8% excluding the impact of the stronger U.S. dollar, reflecting growth across all our operating groups. Expenses were up 6% or 4% excluding the impact of the stronger U.S. dollar and expenses from the acquisition this quarter.

Net operating leverage was 2.9% in the quarter.

Before moving on to taxes, and as a reminder, in Q1 of each year, we expense deferred compensation for employees who are eligible to retire. In Q1 '18, this expense was $111 million, and we would expect some growth from this number in Q1 of '19.

The effective tax rate was 19.7% in the quarter, modestly above last year and below the prior quarter. The effective tax rate on a TEB basis was 22.5%, down from 27.2% last year. The lower tax rate in the quarter reflects the benefit of U.S. tax reform and a favorable U.S. tax item. The favourable U.S. tax item was slightly more than fully offset by the impact of higher reinsurance claims and the legal item in wealth.

Moving to Slide 10, the Common Equity Tier 1 ratio was 11.3%, down 10 basis points from Q3. As shown in the slide, higher retained earnings was more than fully offset by higher risk-weighted assets, the impact of the KGS acquisition and share repurchases. We bought back 1 million shares in the quarter and 10 million shares in the year, while maintaining a strong capital position. As a reminder, we have a capital rule change coming in Q1 that will reduce the CET1 ratio by approximately 10 basis points.

Moving now to our operating groups and starting on Slide 11. Canadian P&C net income was $676 million, with good growth at 8%. Revenue growth was 4%, driven by higher balances across most products, increased non-interest revenue and higher margins. Total loans were up 4%. Mortgage growth through proprietary channels, including amortizing HELOCs was 3%. Strong momentum in commercial continued with loan balances up 12%. Total deposits increased 5%. Personal deposits were up 3%, reflecting 5% growth in chequing account balances and commercial deposit growth was strong at 9%. NIM was up 2 basis points from last quarter in part due to favourable mix. Expense growth was 4% and operating leverage was positive 0.5%. The provision for credit losses was $103 million and includes a $15 million recovery on performing loans.

Moving to U.S. P&C, on Slide 12, and the comments here speak to the U.S. dollar performance. Net income of $294 million was up 31% from last year, results reflect continued strong performance in the business with pre-tax pre-provision earnings growth of 12% and positive operating leverage. Revenue growth was strong at 8% reflecting higher deposit revenue and loan volumes net of loan spread compression. Average loans increased 11% with strong commercial growth, and personal loans also grew. We had double-digit growth in deposits reflecting our continued focus on growing both retail and commercial deposits. Net interest margin was down 2 basis points from last quarter, as higher loan growth at lower spreads was partially offset by higher interest recoveries and improved deposit revenue. Expenses were up 5% and operating leverage was good at 2.7%. Provisions for credit losses were $60 million and included provisions on impaired loans of $46 million and on performing loans of $14 million.

Turning to Slide 13. BMO Capital Markets net income was $309 million. Revenue of $1.1 billion was up 1% with solid performance in Investment and Corporate Banking and softer revenue in Trading Products. Expenses were up 10% from last year due to investments in the business including an acquisition that closed in September, and there was a small recovery in credit provisions in the quarter.

Moving to Slide 14. Wealth Management net income was $229 million, lower than trend. Income in the quarter was largely due to higher reinsurance claims of $34 million and a legal provision of $28 million. Earnings in Traditional Wealth of $202 million were down 2% as business growth was offset with the legal provision. Insurance net income of $27 million, which is well below the level in a typical quarter due to reinsurance claims and also an impact from unfavourable market movements. Expenses increased 5% or 4% excluding a legal provision, largely due to higher revenue-based costs and technology investments.

Turning now to Slide 15 for Corporate Services. The net loss was $68 million compared to a net loss of $102 million a year ago. Adjusted results increased mainly due to higher revenue excluding TEB, and lower expenses.

To conclude, the fourth quarter closed off a good year with progress on our strategic priorities and earnings per share of 10% for the year. We've had good performance over the last 3 years with an EPS CAGR of 8.7%, ROE up 1.3% and the efficiency ratio down 330 basis points. As Darryl said, our operating groups are well positioned, and we feel confident about the future. And with that, I'll hand it over to Pat.

Patrick Cronin Bank of Montreal - CRO

Thank you, Tom, and good morning, everyone. The material risks for the bank were little changed from the last quarter, and we remain comfortable with risk levels in our various businesses.

Starting on Slide 17. The provision for credit losses on impaired loans was $177 million or 18 basis points relative to our total outstanding loans.

That level is flat compared to the prior quarter and consistent with provisions taken throughout fiscal 2018. The total provision for credit losses was $175 million, which included a $2 million reduction in allowances on performing loans.

Looking specifically at our impaired provisions by business unit, the impaired loan provision of $118 million in Canadian P&C was largely flat quarter-over-quarter, resulting in a PCL ratio of 21 basis points relative to total Canadian consumer and commercial loans, which was identical to Q3 2018.

PCL on impaired loans for U.S. P&C increased modestly in both the consumer and commercial portfolios with consumer increasing $3 million and commercial increasing $4 million. This increased the overall PCL ratio on impaired loans for U.S. P&C from 22 basis points to 24 basis points, still well within an acceptable range and consistent with our experience throughout 2018.

Capital Markets had a net recovery on impaired loans of $3 million as a result of a PCL reversal on an oil and gas account that returned to performing status, partially offset by a new reserve also in the oil and gas sector. This continues an overall trend in Capital Markets of very modest PCL or even recoveries through 2018.

Wealth Management was flat quarter-over-quarter at $2 million in PCL.

As mentioned previously, we had a recovery on PCL on performing loans of $2 million. Our allowance for performing loans remain strong with approximately 2 times coverage over this year's provision for impaired loans.

Turning now to the other credit metrics, on the next slide, you can see the gross impaired loans decreased to just under $2 billion this quarter, which is the lowest level of the past 9 quarters. The ratio of gross impaired loans to total loans decreased 5 basis points to 48 basis points overall, reflecting relatively low formations, higher business and government write-offs and the migration of a large oil and gas account back to performing status. Formations were higher in the consumer segment but still consistent with levels seen throughout 2018. In the business and government segment, formations were materially lower driven by declines in several sectors largely reflecting the fairly typical lumpiness of formations in the business segment.

On Slide 19, you can see the delinquency and loss rates for the Canadian residential portfolio, in the mortgage space remained stable.

Turning to Slide 20, we are now providing a view of our outstandings in the energy sector in light of weakness in the commodity prices and widening differentials in Canada. Our energy portfolio represents approximately 2% of total loans and is well-diversified by geography with almost 50% of our energy-related credit outstanding coming now from outside of Canada. Canadian exploration and development, of which almost 3 quarters is investment grade, makes up only 29% of all our energy exposure. If we further segment to look at companies within our energy portfolio that have any exposure to Western Canada Select, the proportion is fairly small at 15% of total energy exposure and only 0.4% of total loans. Within that segment, more than 3 quarters are currently investment grade.

We have a long track record of success in the energy sector and have been through difficult cycles before. We pride ourselves on staying committed to our clients throughout cycles, and we do not see that as inconsistent with prudent risk management. Forecasting potential losses in this segment depends on many variables beyond just the commodity price. So we would guide you to our experience in 2015 and 2016 as a very rough guide for potential change in PCL for the sector, should the current weakness continue.

In summary, we view our credit results for the quarter and for the fiscal year as very strong as our well-diversified credit portfolio benefited from a good economic environment, good credit judgment and strong client relationships.

In terms of outlook for the coming fiscal year, while we are forecasting a generally conducive business environment, we do see a prospect for modestly higher provisions over the next year. We are not seeing specific issues in any of our portfolios, but our overall loss experience in fiscal '18 was at the low end of our historic range, and consequently, we expect some migration to higher levels more into the low 20s in terms of basis points over the coming fiscal 2019. I will now turn the call over to Cam.

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***
Thank you, Pat. 2018 was a strong year for Canadian P&C. We continued to deliver good financial performance including underlying earnings growth of 9%, operating leverage of 1.3% and a 60 basis point improvement in our efficiency ratio. Looking forward, I expect similar operating performance in 2019 with a continued focus on reducing structural cost to enable investment in our strategy while improving efficiency.

My confidence is grounded in 3 main areas: first, we have an excellent commercial business and we are investing to grow nationally. We're #2 in the market and expect strong absolute and relative growth. We are focused on diversifying across industries and geographies outside of our core strengths and have seen strong results including double-digit growth in health care, technology and in the GTA. Second, in personal, we're focused on growing our primary customer base and the strategy is working with strong double-digit improvement in primary customer growth this year versus last. This is good for Canadian P&C and it's good for BMO. From a product perspective, we are focused on deposits, cards and mortgages, where we're significantly increasing our marketing and putting compelling offers and products forward, and we're seeing good momentum with quarter-on-quarter share gains here. And finally, on digital, we're driving customer and business value through great digitally-enabled experiences. I'm very pleased with our strong progress including top tier digital sales performance at 25%, and a market leading mobile banking app. We received the Gartner Eye on Innovation Award for the Americas for our bill pay experience reflective of the strong innovation of our teams. In summary, I'm confident in the results we delivered and the advances we've made against our strategy in 2018, and I'm excited about continuing this momentum into 2019. Over to you, Dave.

Dave Casper ***President & CEO, BMO Harris Bank N.A.***
Thanks, Cam. U.S. P&C delivered record results in 2018, with adjusted net income up 36% and revenue growth of 9%. We had strong loan and deposit growth as well as a favourable rate environment and the impact of U.S. tax reform. All of these contributed to significantly improved results in our U.S. P&C business. Expectations for 2019 are for continued good growth with positive operating leverage, although we do expect revenue growth to moderate somewhat from the very strong levels in 2018, as we expect to pass along higher rates to our customers with the subsequent rate increases. Our personal business continued to show great momentum with strong deposit growth and improving lending trends, and we expect to build on that with enhanced digital strategy to drive higher customer accounts and improved productivity in this business.

The long-term growth strategy for our commercial business remains on track. We continue to add meaningfully to our client base to geographic expansion, increased focus on our specialty businesses and deeper penetration of our existing customer base. Overall, I'm optimistic about our direction and momentum heading into 2019 and believe, we can continue to outperform on a relative basis. With that, I'll pass it to Dan.

Dan Barclay BMO Capital Markets Corp. - Group Head
Good morning. Despite a less constructive environment this year, we continued to deliver good revenue and earnings contribution. We remain well positioned with a diversified, client-focused business model and a prudent approach to risk management.

In Canada, we have leading market share positions across all products and sectors and we intend to competitively protect our business. We will continue to grow our corporate lending books in Canada and the U.S. with an overall growth rate roughly consistent with our experience over the past few years. As I outlined in the Investor Day, our strategy is to accelerate growth in U.S. while maintaining franchise strength in Canada.

We've made several investments to further strengthen our U.S. platform, including the acquisition of KGS-Alpha, the acquisition of loan books and expanding talent in key sectors.

As a result, we are well positioned going into 2019. We have experienced volatility recently, however, assuming markets are constructive, we are confident that we will maintain our strong position and continue to drive momentum across all of our businesses. We expect to deliver strong revenue, income growth and positive operating leverage for the year ahead. Over to Joanna.

Joanna Rotenberg ***Bank of Montreal - Group Head of Wealth Management***
Thanks, Dan. In Wealth Management in 2018, we recorded delivering adjusted net income after tax of $1.1 billion. While we experience some items in the back half of the year that aren't expected to recur, we have a strong underlying performance, including net new assets of $25 billion, which are 50% higher than the prior year with over 80% of our AUM meeting or exceeding their 5-year benchmarks, record loan growth in our North American Private Banking businesses and good deposit growth. In client loyalty, our Net Promoter Scores are up 7 points year-over-year across all of our relationship businesses and we had J.D. Power honours in both Investor Line and Nesbitt Burns and high net new client growth.

We're confident in the strategy we set out at Investor Day, and we are committed to our 5-year goal of doubling our earnings in our wealth business. In 2019, assuming rates continue to rise, we'll deliver strong double-digit net income growth, which will be weighted towards the back half given the recent downward trends in equity markets. We're also expecting similarly high rates of loan and net new asset growth that we delivered this year. Finally, we are reviewing ways to lower our variability in reinsurance with an eye to this year's renewal cycle. In conclusion, we have got good momentum and we're progressing on our strategies and with conducive markets, we'll have a strong year. Back over to the operator.

QUESTIONS AND ANSWERS

John Aiken ***Barclays Bank PLC, Research Division - Director & Senior Analyst***

I guess I get to initiate Dan on his first call. Dan, in terms of the operating leverage that we have seen in the platform, has been negative for last 2 years. Now I know that you've said you've been putting investments in, and the acquisitions have had impact. But you also stated you're expecting positive operating leverage in 2019. Can we take that to mean that the investment phase is starting to slow down, and you're hopefully going to be able to reap what you've sowed?

Dan Barclay BMO Capital Markets Corp. - Group Head

I think that's right conclusion and I hope what you saw during Investor Day, we talked about our scalable U.S. platform. We made good investments to date. This year we accelerated some of those investments as we saw great opportunities to bring forward what we saw in the future. And we believe now we're in a place where we can grow with markets being constructive.

John Aiken ***Barclays Bank PLC, Research Division - Director & Senior Analyst***

And Dan, how confident are you on being able to generate positive operating leverage if markets aren't constructive or aren't helpful?

Dan Barclay BMO Capital Markets Corp. - Group Head

As you know, that's a challenging question and challenging environment to operate in. We'll obviously be adjusting expenses if the market is challenging. With the majority of our expenses being on the employee side, adjusting that will be done in a thoughtful manner as we go forward.

Meny Grauman ***Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research***

Question on the $15 million in recoveries in Canada, I'm just wondering what assumptions are driving this? It just seems surprising giving the outlook, so just wondering, what's the key factor there?

Patrick Cronin Bank of Montreal - CRO

Meny, it's Pat. I assume you're referring to the changes in the performing loan provision, correct?

Meny Grauman ***Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research***

Correct.

Patrick Cronin Bank of Montreal - CRO

Yes. This is going to be maybe a somewhat of an unsatisfactory answer, but if you think about what drives changes in the performing loan bucket, there's a lot of factors that go into that, not the least of which is loan growth, moderating economic forecast variables that we might put into various models, certainly some migration and the migration experience can be different across geographies and within businesses. We do make some changes in weightings between adverse base and benign from one quarter to the next and we did that last quarter and we did it again in this quarter. And then as you know, there's experienced credit judgment that is layered on top of that as well that takes into account lots of factors including portfolio performance differences we're seeing across consumer and commercial but also macro issues that are out there like trade issues and USMCA being a good example. So long story short, there's going to be a lot of noise in those numbers.

I think migration was probably one of the bigger issues this quarter. We had some positive migration in Canada, we had negative migration in the U.S. So that explains some of the difference between the 2 geographies. In the U.S. in particular, there is some deterioration in the Ag portfolio mostly related to grain and dairy. So you're seeing that start to filter through in terms of some of our provisions for performing loans. As you look at things building up in the watch list, you start to make adjustments.

So that's why you're going to see over the course of time some differences in various geographies and businesses that might on the surface be harder to explain. But when you think about all the moving parts that are underneath the performing loan changes, that's really what you got to take into consideration.

Meny Grauman ***Cormark Securities Inc., Research Division - MD & Head of Institutional Equity Research***

I appreciate the detail. One area that you mentioned was just economic assumptions and just to drill into that just a little more, are there some economic assumptions that actually improved over the quarter and if so, would you be able to highlight which ones?

Patrick Cronin Bank of Montreal - CRO

I would say Meny, not to go through the laundry list, that there's a lot of variables that drive the model. I would say, generally speaking, the overall tone of the changes were to moderate our forecast for the future. So nothing dramatic, but we have a slightly more moderate view of economic growth, probably relatively consistent with the general economics view that's out there in the marketplace.

Ebrahim Huseini Poonawala ***BofA Merrill Lynch, Research Division - Director***

Just, I guess, Tom, if you could speak to your expectations around both the Canadian and the U.S. P&C margin relative to where we ended the year in the fourth quarter and your rate assumptions backing that margin forecast.

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

Okay, happy to do that. I'll start with Canada, then go to the U.S. So in Canada, in Q1 and over the next few quarters after that, we would expect the margin to be up 1 to 2 basis points a quarter. And there's some benefit there from rate moves and also positive change in mix, including good deposit growth and good commercial loan growth. And we are assuming a couple of moves by the Bank of Canada in that outlook.

And then in the U.S., our margin in the first quarter, we think, will be down a little bit. That's in part given that we had some recoveries that helped the margin in the current quarter. So we're probably down 2 to 3 bps-ish in the first quarter and after that, we think we'll be relatively flat as we look ahead over the next couple of quarters. And in those assumptions are based on a couple of incremental hikes by the Fed.

Ebrahim Huseini Poonawala ***BofA Merrill Lynch, Research Division - Director***

That's helpful. And is it fair to say that in Canada, if we don't get as many rate hikes as we expect, there's probably downside to the margin, whereas, in the U.S. if the Fed were to stop after the December, there's may be an upside to your margin expectations given the pressure on deposit betas?

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

I would say directionally in Canada, we might go from being up, give or take 2 bps a quarter, to being flattish, if we didn't have the moves. And in the U.S., there is still some benefit from Fed moves, it's not as great, as you know, as it used to be but there is some benefit still. And so if the Fed didn't move, I'd expect a little bit of weakness relative to the numbers that I talked about.

Ebrahim Huseini Poonawala ***BofA Merrill Lynch, Research Division - Director***

Got it. And just a follow-up on the previous questions and on the capital markets expense and investments that you’ve made. Absent a big sort of change in the revenue backdrop, is it fair to assume that the business operates around the 65% adjusted efficiency ratio? Or do you expect it to go back to 60% without sort of a big uptick on revenue? Just trying to understand, you`ve made some investment, expenses have gone up over the last 3 years, how much of this -- those investments paying off will bring down that efficiency ratio?

Dan Barclay BMO Capital Markets Corp. - Group Head

It's Dan here. I think as we look forward, you would've seen at Investor Day, that we were forecasting to take the efficiency ratio down under 60%, that's the goal over the medium term. With obviously the capital market flows and market conditions that will go up and down a little bit quarter-to-quarter, year-to-year, but in the medium term, we expect to get to that, and it is our overall target.

Stephen Gordon Theriault ***Eight Capital, Research Division - Principal & Co-Head of Research***

Couple of things for me. First maybe starting for Cam. Cam, you mentioned an emphasis on cards, the growth has been a little bit modest this year, some big news with the Air Canada resolution. Maybe a bit of an outlook there, do you think you can get to mid to high, how much of a push in cards, can you get to mid- to high single-digit growth? And also I know you restructured the World Elite card offering early in the year. Has that been a drag at all in terms of balance growth this year? And are you sort of revisiting that on the back of your plan for '19?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***

Sure. It's Cam here. The momentum in the cards business has been relatively strong. So at 3%-ish, that's consistent growth quarter-on-quarter from last year. And I expect that we'll continue to build that up into '19. Refreshed product offer, more strength in small business cards, more marketing, better digital offering. So on balance, we feel quite good about it. It will be a more competitive environment to be sure in light of the changes to the dynamic that you mentioned, but I think we are confident on continued growth on the retail cards side including small business.

On the World Elite, I think, the short answer, has there been a drag, would be, no. The World Elite is still an award-winning card in the market and leading the way for us.

Stephen Gordon Theriault ***Eight Capital, Research Division - Principal & Co-Head of Research***

Okay. And then just secondly probably for Tom. Darryl you mentioned in your opening remarks some better trends in consumer in the U.S. Last November you had the mortgage purchase that obviously helped through the year in terms of growth and comps. So I would say probably looks like modest growth in percentage terms excluding that. I'm wondering are portfolio purchases like the one you did last year, is it rising at all on your wish list? Are you thinking about that for 2019? And would it be a nice to have in terms of driving the growth for next year.

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

It's Tom. So we did have the one portfolio purchase in the current year. It was about $2 billion of mortgages in personal U.S. I think importantly, the portfolio did grow organically excluding that acquisition in the year. We felt good about that. And looking out into next year, we think we'll have growth again. And as we've talked about before, we're looking to grow our balances through our existing channels, and given that more consumer credit in the U.S. is being originated through different channels, we're looking to participate in those through relationships. So we expect some flow to come from those in the next year that will help generate the growth. And at the time we did the $2 billion mortgage transaction, we said that, that would be in the upper end of what we would expect, and we wouldn't expect many transactions with that kind of lumpiness. And that continues to be true.

Gabriel Dechaine ***National Bank Financial, Inc., Research Division - Analyst***

Just a quick one on KGS-Alpha. Did I miss that the quantification of the core Tier 1 impact at 22 basis points at some point, it's still a pretty chunky $600 million-plus of capital. I was wondering why it was so large?

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

It's Tom. So the transaction was around 22 basis points. At the time we did the transaction and after that, we talked about an impact, I think, it was of 10 to 12 basis points. That's coming from 2 parts: risk-weighted assets are about 17bps and goodwill and intangibles are about 5 bps on the ratio. And the RWA is a little higher than we thought it would be, and we think that will trend down a bit over the next year as we refine some of our models. Some of their business activities are a little different than the ones that we've had through time. We are totally comfortable with them, but there's a little model refinement that we need to do in order to get the RWA, we think, more reflective of the underlying risk.

Gabriel Dechaine ***National Bank Financial, Inc., Research Division - Analyst***

Okay. And my next question is for Pat, and you did allude to some of the moving pieces behind the influences on your stage 1 and stage 2 allowances in your answer to Meny's question, I'm just wondering, which ones matter more? So you've got the optimistic base case and pessimistic scenarios and some banks seem to have done this big drop in the pessimistic scenario followed by a sharp recovery and others have been more like lower for longer GDP growth. I mean, would you have a similar outcome if you fell in one camp or the other? Do the probabilities matter more? What's the kicker?

Patrick Cronin Bank of Montreal - CRO

I think it's probably a bit too early to say. It's going to I think probably depend a lot on migration, particularly as you get migration in the business segments. Those tend to be lumpy and as they move from stage. And I think you can see a little bit of that actually in some of the disclosure we put around migration between stages in the disclosure this go around. But you can see in the commercial and the corporate segments, those tend to be lumpy in one quarter to the next. So I would say that's probably one of the bigger drivers. On the other end of the spectrum, changes in weightings, particularly small ones like we made from one quarter to the next, tend to have a fairly modest impact and so that's kind of the benchmark. And in between there, variables on the economics side won't necessarily change a lot quarter-to-quarter, and typically our current forecast already reflects, hopefully, a pretty good view of how things are going to play out over the course of time. So we wouldn't expect to change those a lot. So I would say, you're most likely looking at migration as one of the larger drivers of what you're going to see in the performing loans side over the course of the quarters.

Gabriel Dechaine ***National Bank Financial, Inc., Research Division - Analyst***

That's helpful. But if I can sneak in another one - You did mention you've changed some of the weightings last quarter and this quarter. What did you do? And what drove you to do that?

Patrick Cronin Bank of Montreal - CRO

So last quarter, we made a modest increase in the adverse scenario probability reflecting some concerns we saw mostly on the trade front. And then our view is as some of those clouds cleared this quarter, we made a commensurately modest adjustment away from the adverse impact back into base and benign.

Robert Sedran ***CIBC Capital Markets, Research Division - MD & Head of Research***

Thanks for the outlook statements, I find them helpful. I have a question, though, regarding them, when I listened to Cam and Dave. I gather the 2 growth rates are going to converge between Canada and U.S., first, on commercial banking. But what I can't really tell particularly with some of the margin guidance that you gave, Tom, was whether Canada was going to outgrow the U.S. or the U.S. was going to outgrow Canada in terms of earnings growth in '19. Any colour you can provide? And am I right in assuming those 2 are going to converge next year?

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

It's Tom. I'll start out and then others can join if they would like. I would say directionally the answer is yes, in part because we had extraordinary growth in U.S. P&C this year. And our income growth for the year was 30-plus percent and that reflected a great combination of very strong balance sheet growth, higher interest rates and lower taxes. And so next year, you'll see a more traditional, more normal income growth path for the U.S. business. And we do expect continued good growth, and we think the balance sheet will grow at a nice rate. But the growth will come down from those higher levels and so you will see a fair bit of convergence.

Dave Casper ***President & CEO, BMO Harris Bank N.A.***

So Cam and I are sitting here arm wrestling to see who's going to grow more next year. This is Dave. Look, I think we had real good growth this year. We were 9%. We guided a little bit down just because of the NIM and giving some money back to our customers. We're going to continue to grow. We think we'll continue to take share. And we think we'll continue to outperform on the revenue of our peers. And I know Cam, may want to say something too, but I don't know if they converge or not. I think the U.S. is looking pretty good from an economy standpoint. I hope we both grow a lot.

Robert Sedran ***CIBC Capital Markets, Research Division - MD & Head of Research***

Okay. And just quickly, I hate asking about trading revenue but there was a pretty big day, if I look at the histogram and sort of mid to late October, well in excess of anything else in the quarter, is there anything you can tell us about that day and whether it was accounting or business or what it might have been?

Dan Barclay BMO Capital Markets Corp. - Group Head

Sure. It's Dan again. It was one of our franchise clients. It was a trade that we spent considerable time during the year doing. It was on the equity derivative side and it was one transaction.

Doug Young ***Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst***

I guess, this is for Pat. The IFRS 9 disclosure, and thanks for it, it does show what the allowances would be for base case and adverse but not for the upside. And I know each of the banks has decided to provide it a little bit differently, but would you share with us what the weightings are between the different scenarios or what allowances would be for the scenario you didn't provide?

Patrick Cronin Bank of Montreal - CRO

I hate to disappoint you, Doug, but the short answer is we are not disclosing that at the moment. We'll take it under consideration for next quarter. But at the moment, we're comfortable with what we disclosed so far. Our view with respect to disclosing the benign scenario was that it didn't provide a lot of incremental value. Our assumption was the market was more interested in how things might look in the downturn. So that's why we've provided base and adverse, but we'll take that under consideration for a future meeting.

Doug Young ***Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst***

And I'm not picking on BMO. I'm picking on all the banks. Just trying to get some consistency across the disclosure, so that was just one thing that was standing out. And then just on credit, Pat while I have you, it looked like there was a slight increase in writeoffs in the quarter and I haven't, to be honest, peeled through all the details here. I don't know if there's anything in particular that you could note on the writeoff side.

Patrick Cronin Bank of Montreal - CRO

Sure. As you can imagine, writeoffs particularly in the business and government segment can be lumpy from time to time, and that's really all that was for this quarter. We had 3 I would say, normal-sized business writeoffs out of the impaired bucket. And there's nothing sort of sector-wise that I would highlight as a trend there. These things just tend to be lumpy from time to time. You would have seen a commensurate decrease in the gross impaired bucket. It was in the services sector. As you know, that's a fairly diversified sector. So again, no theme with respect to the writeoffs. Those just can be lumpy from time to time.

Doug Young ***Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst***

And then if I can sneak one last one for U.S. NIMs, and you've talked, Tom, about the forecast and what your expectations are. Maybe can you shed some light on are you seeing any increased competition in the U.S. lending market more on being more lenient on commercial lending terms? Because it sounds like, right now, maybe it's a little bit on loan yields, maybe more on deposits. But what we can't see is anything on the terms side. Are you're seeing anything from a competitive standpoint on that side?

Dave Casper ***President & CEO, BMO Harris Bank N.A.***

So this is Dave. I would say the competitive nature in the U.S. has probably been stable over the last couple of quarters. I haven't seen any significant migration downward. Our spreads kind of follow the market. We tend to be, in most cases, we'll go for a little lower spread and a little bit higher credit quality. But as we continue to grow, we'll see some continued diminution in the loan spreads. And we've had really strong loan growth. So no big monumental change to date, but continued modest downward pressure probably. Does that help?

Doug Young ***Desjardins Securities Inc., Research Division - Diversified Financials and Insurance Analyst***

Okay. Yes, perfect.

Mario Mendonca ***TD Securities Equity Research - MD & Research Analyst***

Tom, if we could go to a different lens on your earnings. The segmented numbers, I think you've done a great job, and again, I also appreciate the guidance you guys offer on a segmented basis. But on a total bank basis, really starting from the balance sheet up, there are a few trends that are showing up and we've discussed this in the past. But if you could help me think through some of the things we're observing here, like the increase in securities, and I'm excluding trading here, or cash resources or any of those liquidities. They're up about $49 billion in 2018 or about 26% from Q4 to Q4. Now that's outpacing your loan growth by like a pretty substantial margin. So could you help me think, what are we seeing here? Is there a strategic element to this?

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

A few things, Mario. We have had growth in liquidity on the balance sheet. Some of that results from a view that we do want to have a strong liquidity position. And so some of the growth in liquid assets reflects that decision that we've made. Some of the growth that you're seeing would also be in Capital Markets. Not all of their portfolios are in trading even though the majority of them are. And the growth there would reflect client business that we're doing. And in the quarter, from a quarter-over-quarter perspective, the growth in securities included growth from the acquisition of KGS. And so their balance sheet showed up more in that line than any of the others.

And in addition, in the fourth quarter, we had 2 dynamics at play that contributed a bit to the liquidity. The first was we had very strong deposit growth in our business, and therefore, didn't need as much of the wholesale funding that we had raised to fund the loan growth because we had strong growth in customer deposits. And in addition, we've got some maturities coming up in the first quarter and we've done bit of prefunding around those.

So long answer, but I'd say 3 main points. Number one, we have consciously increased liquidity somewhat over the last year in a bit. Number two, some timing issues related to maturities. And number three, there is growth in client activity in Capital Markets.

Mario Mendonca ***TD Securities Equity Research - MD & Research Analyst***

Okay. And just a quick follow-up then, maybe for you and Pat. Are there any meaningful impacts to the bank's risk profile or capital strength as a result of this growth in 2019?

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

I would say no. The liquid assets, almost by definition, are high quality and don't put a big capital drain on and add to the balance sheet strength, I would say.

Mario Mendonca ***TD Securities Equity Research - MD & Research Analyst***

And then, finally, what you would expect for 2019?

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

I would expect less outsized growth in '19. We are growing the capital market business, but I don't think the growth differential relative to the average on the balance sheet will be as great.

Sumit Malhotra ***Scotiabank Global Banking and Markets - MD of Canadian Financial Services***

First one for Tom, just a couple of clarifications on capital. The point you made on the KGS capital impact and how you might be able to adjust some of the RWA pickup going forward, is that essentially a transitioning the book or restating the book from standardized to advanced that accounts for that difference? And then related also for you, Tom, it sounds like the impact of the upcoming OSFI changes in Q1 is half as much as you previously communicated. Just wanted to confirm that and what may have changed in that regard.

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

Yes, okay. So I'll take the second one first. We think the change in Q1 will be 10 basis points. That's lower than we've previously guided and the big reason there is the change for 10 basis points relates to the change to counter-party credit risk. And as we were going through this year, there was a question about whether we would also have a change for securitization RWA. And as it turns out, we will not have that change in Q1 of this year. It's more like Q1 of next year, so Q1 of 2020. And so that accounts for the drop in the impact in the first quarter. And then in terms of the KGS part of the question, the difference really relates to just reflecting in our models some of the particular business dynamics that go with the business that they do. And their business is focused mainly on U.S. agency paper and we were in that business but not to the same extent, which is why the acquisition was attractive to us. And there's a degree of, I would say, conservatism in the numbers that we've got now just because the position is newer for us, and we need to tune some of our models. And we think that will come out during the course of next year.

Sumit Malhotra ***Scotiabank Global Banking and Markets - MD of Canadian Financial Services***

All right. So I think when all is said and done, you might end up migrating back closer to the original capital impact that you had communicated.

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

Correct.

Sumit Malhotra ***Scotiabank Global Banking and Markets - MD of Canadian Financial Services***

All right. And then moving over to the business for -- I'll start with Cam anyway. When I look at the revenue growth in Canadian P&C, so on a quarterly basis -- looking at year-over-year over the course of 2018, the growth rate in the top line did steadily decelerate. And coming into this year with B20 having come aboard, I think at least I have the view that your lower real estate exposure in Canada would make BMO somewhat better positioned for that. The overall numbers have been fine but the revenue, at the industry level, it's something like 4%. When you start looking out to 2019, and I'm sure you already have, what is the reasonable revenue growth assumption in this business? And what do you realistically need to produce to make positive operating leverage a goal that can be achieved?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***

Thanks for the question. It's Cam here. I think the reasonable revenue prediction for the year ahead is mid-single digits. I think it's going to be building through the course of '19. So it will feel a little different in '19 than it did, I think, in '18. When you look at the revenue right now, I think that there's 2 things at play. One is, maybe half the delta is NIM and half the delta is balances. And the balances primarily would be on the personal side. On NIM, being up 3 doesn't probably tell the full story and that there's timing on these things. If you looked at it from a 5-quarter perspective, Q4 '17, we were up, I think, 4 or 5, if I'm not mistaken then. So we did have margin movement and I expect, as Tom said earlier in the call, we'll be in the 1 to 2 per quarter through '19, which I think will be helpful.

On the balance side, we're leaving Q4 on the commercial business in double digits in loans and deposits, and I expect that will continue at that rate and that should be market leadership type growth.

On the personal side, it's been a story more of the build. We have been a little bit slower on the lending side in retail. But there is strength on the cards business. There's strength in deposits. And I would expect the quarter-on-quarter share gains we have seen, although modest in deposits and in mortgages, if you consider amortizing HELOC, to continue. So what it would take to do the 5-plus percent, I think it's those things. But it's a little more momentum, which we shall see, I think, in the second half of the year on the retail side that will make the big difference.

Nigel R. D'Souza ***Veritas Investment Research Corporation - Investment Analyst***

I just wanted to follow up on a question regarding your Canadian residential mortgage growth and the dynamic of amortizing HELOCs. And I appreciate the additional colour you provided here. So when we look at a 3% year-over-year growth that you provided for mortgages plus amortizing HELOCs, and relative to about a flat residential mortgage book, for me that implies about a $3 billion contribution in terms of the year-over-year increase. And how should we think about it? Is that roughly equal to about nearly $1 billion a quarter of revolving to amortizing convergence? Or how should we think about that dynamic?

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***

Thanks for the question. So yes, I do, I think that we will be in the range you described. So it's 3 blended year-on-year and quarter-on-quarter blended there 2%, so a mid-single digit. The asset balance you described in terms of what it's worth, I think it's likely in the range.

Nigel R. D'Souza ***Veritas Investment Research Corporation - Investment Analyst***

Okay. And just a last quick question, if I could squeeze it in. Again, I appreciate the disclosure, the breakdown of the mix between revolving and amortizing. It's 45% revolving, 55% amortizing. Just to get a better understanding, would you put that growth of the industry on par? Or are you running at amortizing mixes that are relatively higher or lower than peers? Appreciate the colour.

Cameron Fowler ***Bank of Montreal - President of North American Personal & Business Banking***

I must say, I'm not perfectly clear on the competitive position of everybody, but I would say that we are in line to potentially slightly better on the amortizing.

Scott Chan ***Canaccord Genuity Limited, Research Division - Financials & Financial Services Analyst***

Just going back to KGS-Alpha. You kind of cited that it contributed to the higher expense growth in the quarter. But what about the revenue contribution? Or perhaps at a high level, just the state of the U.S. MBS and ABS market?

Dan Barclay BMO Capital Markets Corp. - Group Head

It's Dan here. The contribution was in line with the expense growth overall and consistent with how they run the model. We did have positive income out of that for the first 2 months, and I think we'll expect that to continue through '19.

Scott Chan ***Canaccord Genuity Limited, Research Division - Financials & Financial Services Analyst***

Okay, great. And Joanna, just lastly, on the wealth side, did you guide for double-digit earnings in the back half of '19 or for '19 in total?

Joanna Rotenberg ***Bank of Montreal - Group Head of Wealth Management***

Double-digit earnings in the total year, but emphasized towards the back half in terms of acceleration.

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

Thank you, operator, and thank you all for your questions. In closing, I would reiterate the commitment to our medium-term targets that we made at our Investor Day last month and my confidence in the strength of our foundation, our strategy and our people to achieve them. Our people are our most valuable asset and it really is all 45,000 of us operating as one bank and one team that creates sustainable performance. So to wrap, thank you for joining the call today and we wish all of you the very best for the holiday season and a successful 2019.