BMO Financial Group

Q3 2020 Conference Call

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PRESENTATION

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

Thank you. Good morning 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.

We have with us today Ernie Johannson from Canadian P&C and Dave Casper from U.S. P&C. Dan Barclay is here for BMO Capital Markets and Joanna Rotenberg is here for BMO Wealth Management.

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

On behalf of those speaking today, I note that forward-looking statements may be made during this call. Actual results could differ materially from forecasts, projections or conclusions in these statements.

I would also remind listeners that the Bank uses non-GAAP financial measures to arrive at adjusted results to assess and measure performance by business and the overall Bank. Management assesses performance on a reported and adjusted basis and considers both to be useful in assessing underlying business performance.

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 2019 Annual Report and our Third Quarter 2020 Report to Shareholders.

With that, I will hand things over to Darryl.

Darryl White – Bank of Montreal – CEO

Thank you, Jill, and good morning, everyone. Thank you for joining us today.

Today, we delivered adjusted earnings per share of $1.85 and strong pre-provision pre-tax earnings of $2.6 billion, up 12%, allowing us to absorb prudent loan loss provisioning and deliver sustained capital strength. Year-to-date PPPT was $7 billion, up 7%. Our U.S. segment again demonstrated the value of its mature and scalable platform, with PPPT in the quarter up 31%.

In this challenging environment, diversification matters more than ever. Our diversification, across both businesses and jurisdictions, was a key driver of the strength and resiliency of our financial performance.

For the quarter, our total bank efficiency ratio was 56.8% and operating leverage was 5.3%. Year-to-date, we've delivered operating leverage of 2.9% despite the challenging environment. Expense management was strong in the quarter with expenses down 2% year-over-year, and also from Q2. We are maintaining disciplined expense management, targeting overall expenses to be flat for the year, and we intend to carry this year's disciplined approach into 2021.

We are as committed as ever to be a more agile, more efficient bank and we are applying lessons from the recent experience to accelerate our progress.

Our CET1 ratio is strong at 11.6% and, today, we announced a quarterly dividend of $1.06 per common share.

Together, we've been facing one of the most challenging economic periods in history and, although uncertainty remains, there are signs of optimism. The resiliency of our customers, our employees and the economies we operate in has been admirable.

Adding to the uncertainty of COVID, we've recently been reminded of how far our society still has to go to eliminate racial injustices. BMO will always stand up for a society that is more just, where all people are valued equally. That includes raising our voice to denounce racism; this is integral to reaching our objective of zero barriers to inclusion as we live our Purpose to Boldly Grow the Good in Business and Life.

Turning now to our financial results. Canadian P&C had top-tier momentum going into the crisis. In the quarter, we worked through the impact of lower rates and loan growth, while keeping expenses flat year-over-year, to earn over a billion dollars of PPPT. Looking ahead, we see steady improvement on revenue growth and strong expense management.

U.S. P&C delivered US$486 million of PPPT in the quarter, up 12% year-over-year. With continued discipline and focus on expenses, the business achieved a new low efficiency ratio of 52.8%. Year-to-date, U.S. P&C's efficiency ratio was 54.5%, ahead of schedule relative to our 2018 Investor Day three-year target of the mid-50s. Overall, the business continues to benefit from an integrated strategy that combines the strength of our commercial platform with a focused and growing personal business.

In the quarter, we were one of just eight U.S. banks chosen to offer mobile-first chequing accounts managed via Google Pay. This exciting collaboration with Google is a natural next step in our existing strategy to grow our digital deposits and to support our customers' financial lives in more places where they're spending their digital time.

Before I continue, I want to remind everyone about our virtual Investor Event on September 30, focusing on our North American Commercial Banking business. We look forward to welcoming everyone again, after having had to postpone the event in the spring. Our ability to strategically grow our commercial business, in both Canada and the U.S., while maintaining consistent and prudent underwriting and credit management, has long been a competitive differentiator for BMO. So, we hope you can join us.

Capital Markets had a record quarter with net income of $435 million and PPPT of $716 million, reflecting an improved environment and strong client activity. Operating leverage was very strong, at 24.1%, with an efficiency ratio of 53.1%. Both Global Markets and Investment & Corporate Banking had record revenue performances, reflecting the strength and earnings diversification Capital Markets provides, both in Canada and in the United States. Although this quarter's results benefitted from a particularly active environment, we performed well within it and, looking forward, we firmly believe in the long-term earnings power of our Capital Markets franchise.

Wealth Management also had a very good quarter with net income of $349 million, up 35%, driven by improved global equity markets and strong growth in online brokerage activity and new accounts. Revenue increased 6% year-over-year and expenses declined 5%, with disciplined cost management. Operating leverage was 11.1%, with a new low operating efficiency ratio of 63.7%. Clients continue to trust us with their investments and reward us with their business, as reflected in record client loyalty scores in the quarter.

Despite the challenging environment, we have stayed focused on our core objectives and we continue to drive value against our strategic priorities. I'll leave you with 4 key observations:

1. We have strong operating momentum, having earned $7 billion of PPPT year to date, up 7% from the prior year, with year-to-date operating leverage of 2.9%. And we continue to see long-term opportunities for market share gains and prudent growth in our targeted areas of focus.

2. We added prudently to our allowance for performing loans in the quarter, while at the same time recording a stable impaired loss ratio of 38 bps. With $3 billion of coverage on performing loans, relative to our expectation of future losses, we are appropriately provisioned.

3. We are delivering on expense management and efficiency commitments and we will do more. We are benefitting from the foresight we had at the end of last year, entering what we expected would be a tougher revenue environment, with industry leading expense management and a comprehensive and strategic understanding of the levers that will continue to drive efficiency.

4. We have a strong capital and liquidity position, with a liquidity coverage ratio of 147%. At 11.6% CET1, we have the capacity to continue to absorb the impacts of an uncertain environment, while maintaining flexibility to invest and grow in areas of strategic importance.

Overall, we have the appropriate defensive positioning for an uncertain environment with our diversified business model, meaningful performing loan coverage and more capital than we had before COVID. And, at the same time, our operating momentum has been tested and proven to remain among the best-in-class, setting us up well for the eventual economic recovery.

And as I said at the beginning of this year, we have the energy, the resilience, and the focus and see growth potential across all our businesses. We will continue to drive towards our goals while unwaveringly providing support to our customers and our communities.

I'll now turn it over to Tom.

Tom Flynn – Bank of Montreal – CFO

Thank you, Darryl, and good morning, everyone.

My comments start on slide 8, with the highlights of our results. Our diversified businesses produced good results in Q3 despite the challenges we faced given the pandemic. Pre-provision, pre-tax earnings growth was strong and we continue to be in a very good spot with our capital and liquidity positions.

Q3 reported EPS was $1.81, and net income was $1.2 billion. Adjusted EPS was $1.85, and adjusted net income was $1.3 billion, down from last year due to higher provisions for credit losses. Adjusting items are similar in character to past quarters and are shown on Slide 29.

Turning now to revenue. Third quarter net revenue was $6 billion, up 4% from last year, with good revenue performance in Capital Markets and Wealth, and P&C banking businesses affected by lower interest rates. Net interest income of $3.5 billion, was up 10%. On an ex-trading basis, reflecting lower interest rates and lower results in corporate services. Net non-interest revenue was $2.5 billion compared to $2.6 billion last year.

We continue to focus on expense management. Expenses were down 2% and down 3% in constant currency and excluding a gain on an office building sale last year.

The provision for credit losses was $1.1 billion and Pat will speak to this in his remarks.

Moving to slide 9 for capital. Our capital position continues to be strong and well above regulatory requirements. The Common Equity Tier 1 Ratio was 11.6%, up 60 basis points from Q2. As shown on the slide, the change in the ratio reflects growth in retained earnings, lower risk weighted assets, the adjustment for transitional arrangements for expected credit loss provisioning, and other smaller net positive items.

Lower Risk Weighted Assets primarily reflect a decline in corporate and commercial lending from the elevated levels in the prior quarter, and in addition a lower CVA charge and model changes, with these partially offset by changes in asset quality.

Given the strong capital ratio we have eliminated the discount on the dividend reinvestment plan.

As you know, our U.S. bank holding company recently went through the CCAR and DFAST process and had a stress capital buffer higher than we thought appropriate. The CCAR results will not impact our U.S. strategy or results.

Moving to our Operating Groups and starting on slide 10. Canadian P&C had net income of $320 million, reflecting higher credit provisions and lower revenue. Revenue decreased 4% due to lower non-interest revenue, which was above trend last year. Net interest income was relatively unchanged as higher balances were offset by lower margins. Average loans were up 5%, with commercial loans up 9%. Deposit growth was again strong with personal up 14% and commercial up 31%, reflecting higher liquidity retained by customers in this environment. On an as at period end basis, loans are up 4% from last year. Net interest margin was down 4 basis points from last quarter, primarily due to lower deposit margins, reflecting lower interest rates, partially offset by the benefit of deposits growing faster than loans. Expenses were relatively unchanged from last year as higher pension and technology costs were offset by lower employee-related expenses and lower discretionary expenses. The provision for credit losses was $570 million, with the provision on performing $313 million.

Moving to U.S. P&C on slide 11, and my comments here will speak to the U.S. dollar performance. Net income of $199 million was down from last year due to higher credit provisions, partially offset by lower expenses. Pre-provision pre-tax earnings growth was strong at 12%. Revenue was flat, as higher deposit and loan balances were offset by lower deposit margins and non-interest revenue. Loan growth moderated with average commercial loans up 7% and personal up 6%. Average deposit growth was very good at 32%. On an as at period end basis, loans were up 3% from last year. Net interest margin was down 5 basis points from last quarter, primarily due to lower deposit margins due to the low interest rates, partially offset by loans growing faster than deposits. Expenses were down 9% from last year, with our expense management focus contributing to lower expenses across most areas including technology, employee and advertising expenses. The provision for credit losses was $247 million, with the provision on performing $166 million.

Turning now to slide 12. BMO Capital Markets had very strong results in the quarter, with net income of $435 million. Results reflect good performance in our trading businesses, record earnings in the U.S. Segment, and good performance in Investment and Corporate Banking. Revenue was up 27%. Global Markets revenue increased driven by strong client activity in interest rate and commodities trading, partially offset by lower equities trading. Investment and Corporate Banking revenue was good and increased slightly from last year, with higher corporate banking-related revenue partially offset by lower underwriting and advisory fees. Expenses were up 3% primarily driven by higher performance-based costs, given the revenue performance. The provision for credit losses was $137 million, with the provision on performing $58 million.

Moving to slide 13 for Wealth Management. Wealth had strong results in the quarter with net income of $349 million. Traditional Wealth net income of $279 million was up 19%, reflecting benefits of a disciplined expense management and stronger global markets. Loan and deposit growth continued to be good year-over-year. Insurance net income was $70 million, up $46 million from a below-trend level last year. Expenses were down 5%, reflecting benefits from cost containment programs.

Turning now to slide 14 for Corporate Services. The net loss was $118 million, compared to a net loss of $25 million in the prior year. Results decreased primarily due to lower treasury-related revenue and higher expenses driven by the impact of a gain on a sale of an office building last year.

To conclude, our operating performance in the third quarter was strong and reflects the benefit of a diversified business mix. We remain confident in our ability to manage through the current environment and to execute on our agenda. And with that, I will hand it over to Pat.

Pat Cronin – Bank of Montreal – CRO

Thank you, Tom, and good morning, everyone.

The current COVID-19 pandemic continues to have an impact on our risk profile and the evolving nature of the crisis continues to inform our positioning and provisioning. We remain confident that our strong Risk position going into the crisis and our long track record of successfully managing risk through challenging times will translate into manageable credit results as was the case this quarter.

Starting at slide 16, the provision for credit losses was $1.054 billion, or 89 basis points, down from $1.118 billion, or 94 basis points, last quarter. PCL on impaired loans increased modestly from $413 million last quarter to $446 million this quarter, or from 35 basis points to 38 basis points. The provision for performing loans was $608 million versus $705 million in the prior quarter.

Looking at the PCL on impaired loans results by operating group, the quarter-over-quarter increase was driven by higher provisions in Canadian P&C and Capital Markets, partially offset by lower provisions in U.S. P&C and Wealth Management. PCL on impaired loans in Canadian Consumer increased slightly while Canadian commercial provisions increased principally due to COVID-related losses. U.S. Consumer PCL on impaired loans was flat compared to last quarter, while U.S. commercial losses decreased, including in our Transportation Finance business, highlighting the resilient nature of the U.S. Commercial portfolio and the strong underwriting practices across all of our lending businesses.

Capital Markets impaired losses increased modestly, as Oil & Gas provisions remained at an elevated level, though within the range of our expectations for the quarter. We also saw impairment in COVID-impacted sectors that contributed to Capital Markets' PCL on impaired loans as well this quarter.

Turning to slide 17, the $608 million provision for credit losses on performing loans in the current quarter reflects the impact of the extraordinary and highly uncertain environment on credit conditions, the economy and scenario weights. In particular, while our current credit experience remains within expectations, we believe the possibility of a slower economic recovery increased during the quarter given the resurgence of COVID-19 in many jurisdictions.

The performing loan allowance continues to be appropriate with coverage of trailing four quarter losses at 2.1 times and coverage of the current quarter annualized at 1.7 times.

On Slide 18, impaired formations were $1.76 billion, reflecting stress in certain COVID-19 impacted industries such as Services and Retail, as well as continued migration in the Oil & Gas sector. We also had a large formation for a single borrower in the Financing Products sector, on which we do not expect to take a loss. Gross Impaired Loans were $4.4 billion, or 95bps, up from 74 bps last quarter.

On slide 19, gross loans and acceptances decreased approximately $28 billion, with almost all of the decrease in business and government loans as a result of lower utilization with existing clients and the impact of foreign exchange. Though there has been sizeable variability in business and government loan balances over the past two quarters, our fiscal YTD loan growth is still positive, even excluding government relief programs.

On slide 21, we provide an overview of those sectors where we have seen material COVID impacts on credit quality which have been concentrated largely in sub-segments of Services and Retail Trade. We continue to track these segments very closely and credit conditions are unfolding largely as expected given the macro environment.

Again this quarter, we've provided additional disclosure on customers with payment deferral arrangements, found on page 9 of the MD&A. At the end of Q3, we had 12% of our Consumer balances and 6% of our Commercial balances under deferral arrangements. In our Commercial businesses, a large percentage of the deferrals granted have now come up for expiry and our experience to date has been encouraging, as roughly 90% of these loans have not been extended and delinquency and default rates have been very low so far. While we've had less deferral expiry in our Consumer segments, given the longer deferrals granted, our deferral expiry experience with our Consumer clients has been similarly encouraging so far.

With respect to Consumer deferrals, 89% of the deferred balances are Real Estate Secured Lending, with 97% of those deferred RESL balances in Canada. Of the deferred Canadian RESL balances, the large majority are mortgages, of which 34% are insured. The Credit quality of Consumer deferrals varies by product, but the average bureau score weighted by deferred balances is approximately 745 in Canada and 695 in the U.S. with the average LTV of deferred RESL balances approximately 59% in Canada and 55% in the U.S. Overall, we've seen good performance on deferrals that have matured reflecting the quality of the clients and the collateral.

On Slide 22, we provide further detail on our Oil & Gas loan portfolio. Losses and impaired formations were elevated this quarter but within expectations given the commodity price environment. Our performing provision on Oil & Gas loans is approximately $300 million, representing roughly 2.25% of performing loans and 3.1% of the portfolio, excluding Pipelines.

The majority of our company continues to work remotely, and our operational risk profile remains stable and consistent with our risk appetite. As such, we do not anticipate challenges to operating in this environment for the foreseeable future.

In terms of outlook, there continues to be a high degree of uncertainty around the trajectory of the economic recovery, but we feel with this quarter's addition to our performing loan allowance, we are well prepared and provisioned. We have been pleased with our credit experience so far during this crisis, with credit migration, payment deferral expiry and impaired loan loss provisions well within expectations and utilization rates back to normal levels. With that said, we do expect to see our impaired loan loss rate rise in the coming quarters and would guide to a rate in the 40's, in terms of basis points, for the next few quarters. With that, I'll turn the call over to the operator for the question and answer portion of today's call.

QUESTIONS AND ANSWERS

Ebrahim Poonawala – BofA Merrill Lynch, Research Division – Director

I guess the question is for Pat, just following up, I think, Pat, you mentioned that you expect impaired PCLs to be in the 40-basis-points range. Just talk to us around the visibility that you have when you think about deferrals, probably 90% of them expiring in the fourth quarter, around the formation for impaired loans, both in U.S. and Canada, when we talk to the U.S. banks here, there's still a high degree of uncertainty around how things play out over the next quarter or two, once deferrals come to an end, etc. So, give us a sense of your confidence around what you're seeing on credit and the migration patterns you expect, both in U.S. and Canada over the next quarter or two?

Pat Cronin – Bank of Montreal – CRO

Let me start with formations. Obviously, they were elevated again this quarter, and this is two quarters in a row. Really, what you're seeing there is a couple of things. As I noted in my speech, we did have one very lumpy addition to formations this quarter. It was about $300 million of that total formation number you saw there. And we don't expect to take a loss. We look at our collateral as more than covering our loan value. So, I think you have to be a bit cautious when you look at high formations and even GIL balances, when you think about the impact on losses. And of course, keep in mind that our current impaired loan provisions that we've taken in Q2, Q3, accurately, we think, reflect the impaired balances that we have today. Looking forward, obviously, we're going to see continued stress in the COVID-impacted sectors. And that's really what you're seeing this quarter. You're seeing provisions and formations showing up in Oil & Gas. As we highlighted last quarter, we expect to see that continue for the next two quarters. And that's what's partly informing our thinking about our impaired loss outlook that I just gave you. We've also done some very granular work around the consumer deferred balances. As you can imagine, we have very good information now about cash balances, about credit card spending patterns, and that's allowed us to do some very deep segmentation of that portfolio. And in part, that's what's informed the performing provision this quarter. And so we think we're adequately prepared there for what might be coming when consumer deferrals roll off. And then lastly, another maybe guidepost for you if you want to think about it this way, if you look in our MD&A, we'll disclose what our provision would be if all of our loans were in stage one. That gives you a pretty good estimate of what our loss estimation would be for the next 12 months. That's roughly about 47 basis points, and so pretty consistent with that kind of mid-40s number that I gave you. That, of course, is also informed quite deeply by some very detailed work we've done on the COVID-impacted sectors in wholesale as well. We've got another quarter under our belt of some pretty good analysis of those subsegments. I'd say the good news is, we're seeing the stress across the wholesale portfolio very concentrated in those particular subsectors. And so the rest of the portfolio is actually performing quite well. Based on the detailed work we've done on those segments, the consumer work that we've done, the loss estimation model that triangulates pretty nicely with those numbers, that gives us a fairly good degree of confidence around that mid-40s number. I'll caveat all that by saying the environment is highly uncertain and it really will depend largely on how the pandemic unfolds as we get into the fall. And the risk of a second and third wave is not insignificant, which is why you saw us build the performing provision this quarter.

Ebrahim Poonawala – BofA Merrill Lynch, Research Division – Director

And barring a second or third wave, should we assume performing PCLs go back to closer to pre-COVID levels than what we've seen in the last two quarters?

Pat Cronin – Bank of Montreal – CRO

Yes. We think we're adequately provisioned right now. That provision we took this quarter, obviously, reflects the risk of that second and third wave now. So I would say, barring any real major changes in the macro environment, I would expect to see the performing provision decline quite substantially over the course of the next quarter or two.

John Aiken – Barclays, Research Division – Director & Senior Analyst

The deposit growth that you've experienced has been quite impressive, obviously, as the prepared commentary talking about customers wanting to maintain liquidity. At this stage in the game, do you have any senses in terms of how sticky these deposits may be, and if you don't, when do you think you might have that that sense, and then, Tom, if you can add-on and give us some sense in terms of what impact this heightened level of deposits has had on the NIM compression experienced in the quarter, please?

Tom Flynn – Bank of Montreal – CFO

On the deposits, we feel very, very good, I would say, about our deposit growth. There's lots of liquidity as a general matter in the system and out and about generally, as you know, but our deposit growth has been above average, and it does reflect a big focus that we've had on deposits in the bank over the last few years. And so we're happy to have the liquidity and feel good about the underlying business performance. We do think a portion of the excess deposit flow, that we've seen over the last couple of quarters, declines gradually over the next year or so. And a portion of it, we think, will stay and is permanent. And there's obviously a fair bit of uncertainty around exactly how that plays out. But in our management, we're assuming a portion of the extraordinary flows, with the very, very high-growth rates that you've seen, does result in some gradual decline over the course of the next year. And then I'm glad you asked the question about the impact on NIM. We are sitting on meaningful excess liquidity. We earn a lower rate of return on that liquidity. We're basically invested in short-ish dated securities, and we've got Central Bank deposits and so that does have a downward impact on NIM. And so if you look at the total bank, excluding trading, margin change in the quarter, it was down 17 basis points. Excluding the impact of the higher level of excess liquidity, it would have been down about 10 bps. And so meaningful impact from the excess liquidity. And on the all bank margin, we were down about 11 bps, and around half of that was due to the excess liquidity. And so as we look forward, if some of those deposits do get redeployed, as customers do whatever they're going to do over time, that will have a slight positive impact on NIM over the course of the next year.

Gabriel Dechaine – National Bank Financial, Inc., Research Division – Analyst

Just want to ask about the forbearance number, the loans deferring payment, and if you have some visibility on, when you're modeling, I guess, for how those balances evolve over the next few months or quarters, and where you end up in terms of the percentage that go back to normal payment patterns versus those that don't, and if you can go product by product, obviously, mortgage is the biggest chunk of that?

Pat Cronin – Bank of Montreal – CRO

I'm not sure if you're asking in terms of balances, but that's probably pretty straightforward. We would expect the bulk of the consumer deferrals to roll off in Q4. We wouldn't anticipate giving out additional deferrals there. We think we'll move much more just simply to a case-by-case with our consumer customers after that. And then similarly for wholesale, you can see in the MD&A, a big chunk of the balances have actually already rolled off. And as I indicated in my speech, we're seeing the vast majority of those not opt for a second extension. Typically, we granted about three-month extensions there. Most did not want or need a second extension. And of those, of that very large majority that expired, we're seeing delinquency rates actually quite low. Just in rough, rough order of magnitude, kind of in the kind of 1% to 2% zone delinquency rates in terms of those that expired. So reasonably encouraging. You could make an argument that those that have gone for second extensions, which again, is a pretty small percentage of the total, might be lower credit quality, so you might see that delinquency rate drift up a little bit. But that's how we're thinking about what's going to happen when deferrals roll off. We actually – based on what we're seeing so far – and keep in mind, in consumer, even though you don't really see it in MD&A, we've had about $4 billion of consumer balances also come up for expiry. And you don't see it because we've also given out early in the quarter, we offset that with some additional deferrals we granted. But if you looked at just what consumer deferrals came up for expiry in the quarter, the experience was pretty similar. The vast majority of them don't opt for a second extension and the delinquency levels that we're seeing in that segment are kind of in and around that same ballpark. And so, as we look out, that's why – and again, when you compare that to the performing provisions that we've now taken, which contemplate potential for a W-shaped recovery or extension of the crisis, 57 basis points of coverage in Canadian consumer, gives us some pretty good confidence that, even if that does turn out to be maybe higher delinquencies than we think, there's some good performing provision coverage there as well, and the story is pretty much the same on wholesale.

Gabriel Dechaine – National Bank Financial, Inc., Research Division – Analyst

Great. I was hoping maybe it's just too tough to put a number out there, but is it bulk, when you say the bulk of loans will go back to normal, is that 70%, 80%, 90%, anything you can provide there? Because it does kind of inform how we would calculate our impaired loan balances that should be peaking in 2021.

Pat Cronin – Bank of Montreal – CRO

Yes. I guess it's really hard for me to forecast because it's going to depend so much on the health path that we take over the fall. But all I can tell you is what we're seeing so far, and particularly in wholesale, more than half of the deferrals have now expired. So it's a pretty good data set. And you could think of it as kind of 90% don't need a second extension. And so we'll see what the payment pattern looks like of that 90%, but I would expect it to be – to go back to normal. And so kind of a 90-10 kind of a number is kind of where we are now. And obviously, in the fall, that's going to be higher because the extensions will mature. And so if I had to cuff it, I'd probably put the delinquency rates kind of in the somewhere between kind of 1% to 5%-ish of the deferral balances as they roll.

Paul Holden – CIBC Capital Markets, Research Division – Executive Director of Institutional Equity Research

So one question for you. In terms of your expectations around impairments and/or credit migration, what kind of impact would you expect that to have on CET1 over the next 12 to 18 months? Any kind of guidance you can provide us there would be helpful.

Tom Flynn – Bank of Montreal – CFO

The short answer would be, we don't think it will be a significant factor on the CET1 ratio. We've looked at how different scenarios playing out related to the deferred loans might impact the CET1 ratio. And that works as the number shouldn't be large. We don't expect it to be a big thing that we would be talking about in Q4 or Q1. And then if you broaden the question out a bit and go to migration generally, we expect a little bit of pressure all else equal from the margin as a result of migration, which we've talked about before, but obviously, feel good about where the ratio landed in the quarter and our ability to absorb that.

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

Probably sticking with Tom, after the big swing in CET1, a couple of other sort of follow-ups from Paul in terms of asset quality. Can you talk about, when we think about going forward, have we seen most of the impact from the reversal of the drawdowns, has that mostly run its course, also wondering, Tom, if you can give us a little bit of some color around the model updates?

Tom Flynn – Bank of Montreal – CFO

On the first question related to whether we've seen the impact of the reversal of the long draws. I would say that the answer to that is – yes. So in Q2, we and the industry saw a very significant loan growth resulting from higher loan utilization, that put some pressure on the ratio for us and for others. And this quarter, those draws basically reversed. And it was a pretty amazing curve when you look at it. It was a sharp spike up in Q2 and then a steep glide path down in Q3. And we're now back to pretty much a normalized level. So I wouldn't expect any meaningful ongoing movement one way or another from that. I think it is important to note that although we had the movement in balances related to the line draw activity. Business and government loans are actually up 3% from the end of Q1 to the end of Q3. So there is underlying growth in the portfolio through that period despite the big up and the big down. And then on the ratio, generally, we're comfortable with it. We expect a little bit of migration going forward. Growth will be dependent to a degree on the outlook for the economy, but we expect the ratio to continue to be above 11% as we look forward over the next several quarters.

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

Is it too early, do you think about removing the DRIP discount, or do you let that run its course a little bit just given the continued uncertainty?

Tom Flynn – Bank of Montreal – CFO

We have announced in the materials that we have eliminated the DRIP discount. So we turned it on at a moment in the pandemic when there was very high uncertainty, and we had the very significant line draw utilization that we talked about. And so we don't have any regrets over having done it, but given where we sit now, it's not needed and we have eliminated it.

Doug Young – Desjardins Securities – Diversified Financials & Insurance Analyst

Just maybe back to Pat, I just want to maybe get a better understanding of what drove the performing loan PCLs, because it doesn't sound like it was changing your FLI, it doesn't sound like it was a change in your scenario weightings, was this more a management overlay and just taking a look at migration, and then just kind of tangled into that, as you've indicated that you expect performing loan PCLs to move quite a bit lower and subsequent to this, after this quarter, should we just be thinking about growth and a little bit from migration as being the two main drivers?

Pat Cronin – Bank of Montreal – CRO

I'll start with your last question first. The answer is – yes. We would expect, going forward, you're definitely going to still continue to see migration. As I said in my opening comments, migration has actually unfolded a bit somewhat better than we would have expected. But that will still be a feature in coming quarters, and then we would expect a return to loan growth, and so that balance increase will drive it. In terms of our thinking around the $608 million, it's really a combination of a few things. You're right, the macro changes didn't really drive much this quarter and balance changes actually reduced the provision. We did see some migration in there, and so that put some upward pressure on it, but again, somewhat less than we thought. So really it was a function, we did change our scenario weights this quarter shifting reduced weighting on the benign scenario, just given the heightened uncertainty in Q3 relative to Q2, we thought the possibility of the optimistic scenario had definitely declined. And then maybe more importantly, what's driving the weighting of the adverse scenario is, as I said in my comments, the belief that there is now kind of a fourth scenario out there, the W-shape that has really the effect that's a nonlinear effect on credit losses. The longer we go, the more you start causing stress in companies outside of some of the more COVID-impacted sectors. And so we tried to capture that with a heavier weighting on our adverse scenario. So that was a scenario weight change. And then we did apply some expert credit judgment this quarter for a couple of reasons. One, that with the very granular work that I referred to on the consumer deferred population, we now have a quarter worth of spending pattern and behavioral pattern data on those customers. So we have a better sense where the high-risk customers are and so we topped up the estimate based on that additional work that we had done. We did put in some additional provisions for, based on what we were seeing in some of the COVID-impacted sectors, our view is that loss estimation models that look back at history, can't really factor in the very unique impact on things like hotels and restaurants and fitness facilities, where they're not just exposed to economic decline, but outright closure. And then lastly, we are seeing some slightly higher loss given default rates as we work out some of our distressed loans. In this environment, the workout options are just lower than they would be in a normal environment. And so as we roll forward, we would expect that to continue, particularly for those COVID-stressed sectors. And so we wanted to factor that in as well. And the cumulative effect of all of that added up to the $608 million that you see this quarter.

Doug Young – Desjardins Securities – Diversified Financials & Insurance Analyst

So I guess, it could be growth, it can be migration and then if duration changes relative to your expectations, that's another thing to think about?

Pat Cronin – Bank of Montreal – CRO

Yes, that's absolutely correct. But with that said, we think when we now look at our total coverage, we actually are acknowledging the risk of some extension in duration already. So unless it gets quite a bit worse in terms of expected duration, we think we're covered. I have to caveat all that with, of course, there's a huge amount of uncertainty out there. But we have started to factor in that risk of elongation of the recovery.

Darko Mihelic – RBC Capital Markets, Research Division – MD & Equity Analyst

Maybe staying with Pat, one of the things that might be helpful for us is to understand amongst your deferral portfolio, on the consumer side, how many are receiving CERB payments and, of the $4 billion that was repaid, is the delinquency ratio so small because they're actually receiving CERB payments still, and similarly, on the commercial side, how many of your commercial borrowers are tapping government programs, maybe that would be a helpful statistic to know?

Darryl White – Bank of Montreal – CEO

Darko, it's Darryl. I'm going to suggest we ask Ernie to come in on the first part of your question on how the consumer is behaving around CERB, and then Pat can cap you off on the outlook.

Ernie Johannson – Bank of Montreal – Group Head, North American Personal & Business Banking

Darko, just a quick response on the CERB. What we typically find is that, particularly in the lower end or the higher risk segments, we will see a little bit more CERB. So out of all the CERB customers we have in our franchise today, about 10% of them are in our hardship program, and that gives you a perspective of the size. So it's not a full driver, but it certainly is present – let me use that language. And so as we think about going forward, as we see customers coming out of the program, we're monitoring their behaviors. As Pat has already said, they're making payments. And just a particular note, right now, we currently have a large portion of those in hardship continuing to make payments as well.

Pat Cronin – Bank of Montreal – CRO

And then with respect to wholesale, I think, I don't have the number in front of me, but I can tell you that it's a fairly modest proportion, particularly when you think about the fact that there isn't really a lot of direct to wholesale support coming from the government relief programs. And the Canadian portfolio actually now has the disproportionate share of deferrals. We actually have seen a higher level of deferrals expire in the U.S. than in Canada, just given the size of some of the accounts in Canada, they tend to be smaller and of slightly lower credit quality that are taking deferrals. So the amount that are on government relief or have taken government relief loans in our wholesale portfolios is relatively small.

Darko Mihelic – RBC Capital Markets, Research Division – MD & Equity Analyst

Just to follow-up with Ernie's answer, the 10% number, is that 10% of the deferred what you called the hardship program, or do you mean 10% of the total portfolio?

Ernie Johannson – Bank of Montreal – Group Head, North American Personal & Business Banking

Of the total portfolio of CERB approximately 10% are on deferral program. So what we're finding is you have a number of customers who are in the deferral program that are not on CERB and are continuing to make payments as well, as I said.

Mario Mendonca – TD Securities Equity Research – MD & Research Analyst

If you could just sort of clean that one up, just so I understand a little better, Pat, in building up the provisions, are you contemplating a period when the government support, both for individuals and for corporates, has expired, are you trying to build that into your allowances?

Pat Cronin – Bank of Montreal – CRO

I would say not explicitly, but certainly when I talk about the potential for a W-shaped recovery and the impact that would have, that you could see that the cause of that might be a reduction in government relief payments, but we certainly haven't contemplated that specifically as we think about the numbers, no.

Mario Mendonca – TD Securities Equity Research – MD & Research Analyst

So just if we look forward then, how should we think about this impacting your results, could we see some period in 2021 then, where impaired loan losses move materially higher, but they're not necessarily offset by the release of the performing loan losses, is that something that could play out?

Pat Cronin – Bank of Montreal – CRO

Yes. That's really going to be a function of the trajectory of the pandemic. And certainly, if we see a recovery much faster than the performing provision now contemplates, then the mathematical answer to that would be yes.

Mario Mendonca – TD Securities Equity Research – MD & Research Analyst

Okay. Just a one real quick one. On the liquidities, the one ratio that I keep track of, and I'm not suggesting that it's something that the bank will be familiar with, but just capturing all your liquidities and comparing that to your loan balance, that number has obviously grown a lot in the last few quarters, it's up to something like 71%, last year it was probably in the mid-50s. How do you look at that, or how do you look at liquidities going forward, should that normalize in the next few quarters back to the historical pattern of about sort of 55%, 56%, liquidities to loans?

Tom Flynn – Bank of Montreal – CFO

You can look at different balance sheet metrics related to the amount of liquidity on the balance sheet and, regardless of the metric you look at, the conclusion would be that we currently have a lot of liquidity on the balance sheet. It reflects the liquidity in the system. I think a degree of conservative behavior on the part of retail and commercial customers. And we do expect the excess liquidity to decline gradually over time. And so that means it likely sticks around through most of next year and potentially a bit into the following year. And the way we look at it is we manage the balance sheet in its components. And so at a point in time, we have an amount of what we consider to be just pure outright excess liquidity. And that's over and above all the needs we would have on the balance sheet, including the amount of normal, what we call, supplemental liquidity that we hold, which is kind of a liquidity buffer. And all of that liquidity, as we talked about earlier, is putting some downward pressure on the net interest margin. As the liquidity comes down over the course of the next year or so, that will be a bit of a positive impact on the margin. And from a P&L perspective, it actually isn't a big deal because there's uncertainty about the timing of the reversal of the strong flows, we're investing that excess liquidity in a way that gives us good underlying asset liquidity. And so the yields we're earning are relatively low. And net-net, when you look at what we pay to the customers, it's not a big item one way or the other from a P&L perspective.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

The question I wanted to ask was just a follow-up on capital. We've gone through the mother of all stress tests now. So really, wondering is there any validity to the view that we went into this crisis with capital ratios that were too high and, as you look to the other side, would you be comfortable running with lower capital ratios, given that you're at 11.6% now, we've had, again, the biggest crisis we could ever imagine, and it looks to be in great shape, you eliminated the DRIP discount – so I'm just wondering your thoughts on that?

Tom Flynn – Bank of Montreal – CFO

My mind actually goes to a slightly different place on the question. We feel very good about the capital ratio – that was true last quarter and it's true this quarter. We think we've got lots of capital for the risk in the business and to convey confidence to our stakeholders. And one of the outstanding questions that the market has kind of had, I would say, around bank valuations is whether, over time, there would be some higher multiple attach to the sector given the reduced risk that results from higher capital levels and higher liquidity levels. And the industry, as you know, relative to ten years ago, is operating with much, much, much higher levels of capital and liquidity. Multiples, I would say, really haven't rerated to reflect that greater stability. And so we'd have some hope, when we get through this, that people will look back and reflect on the multiple given the higher security that results from the capital position. Maybe there's a little bit of room on the capital ratio itself, but the stronger thought I have is around the quality of the balance sheet, the quality of the income stream and the resulting multiple.

Nigel D'Souza – Veritas Investment Research – Investment Analyst

So Pat, you mentioned that you took a fairly close look at the deferral balances this quarter, and you scrubbed it fairly well, and I was wondering if you could touch on the mix of Stage 2 loans in the deferral book, and if there was a meaningful increase in those Stage 2 loans, and the reason I ask that is because when I look at your Stage 2 balances, I mean, they moved marginally higher from mortgages in commercial, but they're actually down for credit cards and other consumers, so that impact to performing loans in the quarter from the deferrals, was that driven by higher migration of Stage 2, or did you take and build more allowances in what you already had placed in Stage 2 for deferral loans, or is it a bit of both?

Pat Cronin – Bank of Montreal – CRO

Yes. It's actually a little bit of both. I think that what you may have seen over the course of Q2 and Q3, really the only thing that happened that was different that caused impaired formations to be different over the two quarters was changes in collections practices. So we actually reduced our intensity of collections quite a bit in Q2, obviously, to be sensitive to our customers that were under stress. And then we resumed normal collections practices in Q3, and that caused some distortion in migration between stages over the quarter and a little bit of distortion in the build of the impaired loan balances between the two quarters.

Nigel D'Souza – Veritas Investment Research – Investment Analyst

Okay. And any comments on Stage 2 relative to the deferrals itself, have you meaningfully increased the amount sitting in Stage 2 currently, or is that relatively kind of the same?

Pat Cronin – Bank of Montreal – CRO

It's relatively the same.

Darryl White – Bank of Montreal – CEO

I will wrap up with a recap of some of the key drivers that we think about from the perspective of our performance and our positioning for the future. There are four of them.

Number one, we have strong operating performance and momentum. You've all had a lot of great questions for Tom and Pat through this call, and it's been fun to watch them work, but we also want to acknowledge the great performance of our operating businesses that have come through in a really good way through the particularly challenging environment. And we think we have further opportunities for targeted share gains and growth over time.

Secondly, as you heard today, we are prudently provisioned. We expect to continue to outperform the industry on credit, which has been a defining strength of BMO for decades.

Thirdly, we are delivering on our expense commitments to you, and we expect to do more.

And fourthly, as you heard today, we've got a strong capital position at 11.6% CET1 and liquidity at 147% LCR, which tells you that we have the capacity to absorb any additional uncertainty while at the same time maintaining the flexibility to invest and grow.

Putting it all together, I think what you're seeing in this quarter is the strength and resilience of our diversified business model, tested and proven, performing well. And we're confident in both our defensive positioning and our ability to outperform in the eventual economic recovery.

Thank you all for your time today. We look forward to speaking to you again on September 30 at our Investor Event.