BMO Financial Group

Q2 2021 Conference Call

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PRESENTATION

Christine Viau - *Bank of Montreal - Head of Investor Relations*

Thank you, and good morning. Welcome to BMO's second quarter 2021 results presentation. We will begin the call with remarks from Darryl White, BMO's CEO; followed by Tayfun Tuzun, our Chief Financial Officer; and Pat Cronin, our Chief Risk Officer. Also present to take questions today are Ernie Johannson from Canadian P&C; Dave Casper from U.S P&C; Dan Barclay from BMO Capital Markets; and Joanna Rotenberg from BMO Wealth Management.

As noted on Slide 2, forward-looking statements may be made during this call, which involve assumptions that have inherent risks and uncertainties. Actual results could differ materially from these statements. I would also remind listeners that the bank uses non-GAAP financial measures to arrive at adjusted results. Management measures performance on a reported and adjusted basis and considers both to be useful in assessing underlying business performance.

Darryl and Tayfun will be referring to adjusted results in their remarks unless otherwise noted as reported.

And with that, I will turn the call over to Darryl.

Darryl White - *Bank of Montreal - CEO*

Thank you, Christine, and good morning, everyone. It has been over a year since the onset of the coronavirus pandemic, which has brought challenges unlike any we faced before and that will have impacts for some time to come. But as we transition to recovery, there are more hopeful signs every day. We're proud to have supported our customers and communities as they navigate the disruption and uncertainty of the pandemic. And with them, we have grown stronger, underpinned by our purpose-driven strategy and the culture that will help drive a sustainable and inclusive recovery.

We continue to deliver on our commitments with sustained, consistent financial performance. Today, we announced another quarter of very strong results with adjusted net income of $2.1 billion and earnings per share of $3.13, up from $3.06 last quarter. Each of our operating groups continues to perform very well, with continued strength in our market-sensitive businesses as well as good growth in our P&C businesses, despite record low interest rates.

For the first half of the year, adjusted pre-provision pre-tax earnings of $5.5 billion increased 27%. Revenue grew 11% and expenses continued to be well-managed, up 1% year-to-date, with strong overall operating leverage of 9.8%. Our credit quality remains very strong with low impaired provisions again this quarter and a modest recovery of performing loan provisions, reflecting both the resilience of our customers and our differentiated approach to risk management.

Our return on equity increased again this quarter to 16.7%, above our mid-term target while our capital position continues to strengthen with a CET1 ratio of 13%.

We're on a continuous path to building a strong and even more competitive bank, digitally-enabled, future-ready with leading efficiency improvement, customer loyalty and profitability and a steadfast commitment to the communities we serve. Our progress is evident in our financial performance, which confirms the effectiveness of our strategy and ability to support millions of clients in new ways.

Compared to the first quarter of 2020, efficiency has continued to improve, down 370 basis points to 56.6%, reflecting our commitment to managing expenses while investing for future revenue growth. We're committed to continue to improve efficiency over time even when expense growth reflects our strong revenue performance.

We continue to outperform on credit. We have $2.8 billion of allowances against performing loans, well above our base case expectations for future losses.

Over the same period, return on equity increased 320 basis points with each of our businesses achieving higher levels of earnings and ROE. Our capital position has never been stronger with our CET1 ratio up 160 basis points, positioning us well for growth and the eventual relaxing of constraints on returning capital to shareholders.

We're taking actions to optimize capital and resource allocation. You've seen that reflected in a range of recent decisions such as the sale of our EMEA Asset Management business, our Private Banking business in Hong Kong and Singapore and the wind down of our non-Canadian energy portfolio. These actions further strengthen the earnings power of the bank. And together, they are expected to improve efficiency by approximately 60 basis points, ROE by 30 basis points and capital by 80 basis points, and they enable reinvestment in our core businesses in North America.

We've achieved these results while adapting to the changes and challenges of the last year. And with the economic recovery set to accelerate through this year and 2022, we've never been better positioned to continue to grow with our customers. Substantial fiscal stimulus, pent-up demand and elevated household savings are expected to strengthen economic activity this year and next. Business confidence is much improved. On Monday, the U.S. National Association of Business Economists matched our forecast calling for 6.5% U.S. real GDP growth in 2021, the strongest expansion in 37 years. And among consumers, this week, the Bloomberg Nanos Canadian Confidence Index hit its highest point recorded since they started pulling in 2008, with Canadian real GDP expected to grow 6% as vaccine rollouts accelerate.

Here, we're building capabilities and continuing to invest in our businesses for growth with a digital first strategy digital-first strategy. Our bank has been driving digital transformation for more than a decade. And in the last 12 months, the pace has meaningfully accelerated. This quarter, we launched automated digital enrollment, a solution that quickly and seamlessly enrolls customers into a commonly used mobile banking feature, a first for a major Canadian financial institution. We're accelerating our strong digital sales performance, driven by continued deployment of market-leading capabilities and offers, while continuing to shift service transactions to digital allowing our employees to focus on advice and sales.

In our leading Treasury Payment Solutions business, wire payments are now processed on a single North American platform, 95% without human intervention, resulting in improved speed, less risk for error and a better experience for our customers and our employees. In Wealth Management, we launched adviceDirect Premium, a new offering designed for our self-directed clients with more complex needs. This hybrid solution combines the strong technology of our digital advice engine with human support and planning when it's needed. These are examples of investments driving strong and resilient performance across our operating groups.

Our flagship Canadian P&C business delivered year-to-date revenue growth of 5%, strong operating leverage and PPPT growth of 11% with ROE improving to 26.8%. Performance was supported by continued strong mortgage growth and a resumption of commercial lending growth. In U.S. P&C, PPPT growth was also strong, up 22% year-to-date with revenue growth of 6% and effectively managed expenses. Our efficiency ratio improved to 48.6% and ROE to 16.4%. We're continuing to add clients and deepen relationships with strong growth in commercial deposits and core retail chequing balances, with lending expected to accelerate as the economy expands and supply chain issues ease.

In BMO Wealth Management, we had a strong PPPT growth of 53% year-to-date. Revenue grew 14% in Traditional Wealth with strong growth in client assets, online broker revenue and mutual fund revenue, where sales year-to-date are more than double all of fiscal 2020. These results were complemented by record client loyalty scores in Canadian and U.S. Private Wealth businesses. We're refocusing the business for North American growth, investing in key areas of competitive strength in Private Wealth, in digital investing and Canadian Asset Management that we expect will continue to contribute strongly to the bank's growth.

BMO Capital Markets continues to be a source of diversified earnings to the overall bank and had another very strong quarter, delivering very strong year-to-date PPPT growth of 72% and ROE of 18.9% [sic]. Results reflect strong and diverse revenue performance in both Global Markets and Investment and Corporate Banking and the benefit of actions we've taken over the past few years to further strengthen and reposition the business for sustained performance with new capabilities, deeper relationships and improved efficiency and returns.

Our overall U.S. segment is a key driver of earnings growth, contributing 40% of total bank earnings year-to-date. Pre-provision pre-tax earnings were up 46% with an efficiency ratio of 55%. Our integrated approach brings the full value and scale of BMO to our North American customers, leveraging our top-tier commercial lending market position, leading deposit share in core footprint and a growing strategically-focused capital markets and private wealth management presence.

We're leveraging our strong and consistent financial performance for the benefit of our customers and to support a sustainable and inclusive recovery. We continue to facilitate access to a number of programs for those customers that continue to be impacted by the pandemic to bridge them to an eventual full reopening of the economy. We're addressing key barriers faced by minorities, including targeting financing for women and minority-owned businesses, and supporting community reinvestment through programs such as BMO EMpower and our announced $10 million donation to create the new Rush BMO Institute for Health Equity in Chicago.

Building on our long-standing commitment to a sustainable future and support for the Paris Climate Agreement, this quarter, we declared our ambition to be our client's lead partner in the transition to a net zero world and created the BMO Climate Institute to drive insights and enhance climate resilience.

So while the impacts of the pandemic are not yet fully behind us, the North American economy is poised for a strong recovery through 2021 and into 2022, and we will continue to help our customers make real financial progress. We have operating momentum in our businesses, differentiated risk management and flexibility for capital deployment. I'm confident that we've never been better positioned for the opportunities ahead.

I'll now turn it over to Tayfun to talk about the second quarter financial results.

Tayfun Tuzun - *Bank of Montreal - CFO*

Thank you, Darryl. Good morning and thank you for joining us. I will start my comments on Slide 12. Performance this quarter was solid with strong adjusted pre-provision pre-tax earnings, positive operating leverage and continued momentum across each of our businesses.

Second quarter reported EPS was $1.91 and net income was $1.3 billion. Adjusted EPS was $3.13 and adjusted net income was $2.1 billion, up from the low level in the prior year and up 3% from a strong first quarter.

Second quarter adjusted return on equity was 16.7%, up from 15.8% last quarter, and the efficiency ratio was 56.6%.

The adjusting items this quarter include impacts of divestitures that totaled $772 million after tax, comprising a $747 million write-down of goodwill related to the announced sale of our EMEA Asset Management business, a $22 million after-tax gain from the sale of our Private Banking business in Hong Kong and Singapore and $47 million after-tax divestiture-related costs for both transactions. Adjusting items are shown on Slide 35.

Net revenue was $6.3 billion, up 16% from last year with good growth across each of our businesses and continued strength in our capital markets and wealth businesses.

Expenses were up 3% from last year and flat quarter-over-quarter. Revenue and expenses in the quarter include certain notable items, that combined, did not significantly impact net income. These included elevated card revenue, reflecting non-recurring items in Canadian P&C, a legal provision in Wealth Management and higher expenses related to real estate management.

Credit results were very strong. The total provision for credit losses was $60 million compared with $156 million last quarter, and included a recovery of the provision for performing loans of $95 million. Pat will speak to these in his remarks.

Moving to the balance sheet on Slide 13, average loans were down 4% year-over-year or 1%, excluding the impact of the weaker U.S. dollar due to last year's elevated commercial line utilization rates and decline in the non-Canadian Energy portfolio while consumer loans increased due to strong mortgage growth in Canadian P&C. Compared to last quarter, loans were relatively stable with commercial loans in both P&C businesses, up 2% and continued good mortgage growth, while balances in Capital Markets declined.

Average customer deposits were up 15% year-over-year and up 1% on a linked-quarter basis, reflecting the highly liquid corporate and consumer balance sheets. Looking ahead, we expect loan growth to steadily increase in Canada, supported by growth in both personal and commercial loans. In the U.S., we expect loan growth to ramp up past the near-term supply chain and low inventory challenges.

Moving to Slide 14 for capital. Our capital position strengthened further this quarter. The Common Equity Tier 1 ratio was 13%, up 60 basis points from 12.4% in the first quarter, predominantly reflecting the impact of strong internal capital generation and lower risk-weighted assets. We expect our regulatory capital ratios to continue to grow under the current constraints on capital management actions.

Turning to Slide 15. Net interest income was down 2% from last year on both a reported and ex trading basis. Total bank net interest margin, ex trading, was up 1 basis point from the prior quarter as higher loan spreads offset lower deposit spreads.

In our P&C businesses, both in the U.S. and Canada, margin was stable. In Canada, the benefit of higher prepayment fees was offset by lower deposit margins and changes in mix. And in the U.S., the benefit of higher loan spreads and accelerated fee income on PPP loans was offset by lower deposit margins.

We expect our consolidated NIM to be relatively stable during the remainder of the year and net interest income to remain roughly flat year-over-year. P&C NIMs are expected to decline due to the impact of lower long-term rates rolling in and the expectation for loan growth exceeding deposit growth. Lower prepayment fees are expected to put pressure on Canadian P&C NIM while U.S. P&C NIM is expected to still be supported by PPP fees next quarter, offsetting some pressure from deposit spreads and mix through the remainder of the year.

Moving on to Slide 16, we provided additional information on our interest rate sensitivity. As shown on the slide, a 100 basis point rate shock is expected to benefit net interest income by approximately $300 million over the next 12 months, 2/3 driven by short rate impacts. The impact will be higher if we retain the excess deposits that are currently on our balance sheet. The impact of a 25 basis point increase in short-term rates would add approximately $100 million to revenue over the next 12 months. The higher second year benefit to rising rates would be primarily driven by reinvestment of capital and deposits at higher yields.

Turning to Slide 17. Non-interest revenue, net of CCPB, was up 3% from the prior quarter, primarily driven by strong underwriting and advisory fees as well as higher cards revenue, partially due to non-recurring items, and mutual fund revenue. Year-over-year comparison in non-interest revenue benefited from last year's challenging market conditions. Although market conditions may cause some period-to-period volatility, overall, items that benefit from reopening economies are very well-positioned to see more growth.

Moving to Slide 18, expenses were flat quarter-over-quarter as lower employee-related costs, including the impact of fewer days in the current quarter were offset by higher marketing and technology-related costs. Expenses were up year-over-year, reflecting higher performance-based compensation and technology-related costs offset by lower salaries and travel and business development spend.

Efficiency was 56.6%, and operating leverage was strong at 13.1%. Full year expenses should remain well managed. Any incremental increase over last year predominantly will be driven by performance-based compensation due to significant revenue growth.

Moving to the operating groups and starting on Slide 19. Canadian P&C net income was $765 million, up from $363 million last year, reflecting pre-provision pre-tax earnings growth of 19%. Revenue was up 9% from the prior year and up 2% from last quarter. Expenses were flat to last year and up 2% from last quarter. Operating leverage was strong and efficiency was 45.4%. Average loans were up 3% from last year and up 2% quarter-over-quarter. Deposit growth continued to be strong, up 13% year-over-year. The provision for credit losses was $141 million.

Moving to U.S. P&C on Slide 20. My comments here will speak to the U.S. dollar performance. Net income of $439 million compared to $253 million in the prior year. The strong results this quarter reflect 19% pre-provision pre-tax growth and strong operating leverage. Revenue was up 4% from last year, reflecting growth in both net interest income and non-interest revenue, down 1% from last quarter due to fewer days. Net interest margin was flat sequentially. Expenses were down 8% from last year driven by lower technology and employee-related costs and up from last quarter, including the impact of technology costs. Operating leverage was strong at 12% and efficiency ratio was 49.2%.

On the balance sheet, average commercial loans were stable year-over-year and up 2% quarter-over-quarter. Personal lending balances declined year-over-year. Average deposit growth continued to be strong, up 18%. There was a net recovery of $19 million in the provision for credit losses.

Moving to Slide 21, Wealth Management had very good results with net income of $353 million. Traditional Wealth net income was strong at $303 million, reflecting higher revenue due to growth in client assets and stronger global markets. Insurance net income was $50 million compared to a loss of $16 million a year ago. Expenses were up 6% from last year due to higher revenue-based costs. Assets under management and assets under administration, both increased 13%.

Turning to Slide 22. BMO Capital Markets had another strong quarter with net income of $570 million. Global Markets revenue increased, driven by higher trading and new debt and equity issuances. Higher revenue and Investment and Corporate Banking was driven by strong underwriting activity and net securities gains in the quarter. Expenses were up 10%, reflecting mostly higher performance-based costs, partially offset by lower operating costs and down 5% sequentially. There was a recovery in the provision for credit losses of $55 million.

Turning now to Slide 23 for Corporate Services. The net loss was $140 million compared to a net loss of $82 million last year.

To conclude, performance this quarter demonstrates the benefits of our diversified business model. Our continued focus on efficiency and strategic investments position us well for further growth and profitability.

And with that, I will turn it over to Pat.

Pat Cronin - *Bank of Montreal - CRO*

Thank you, Tayfun, and good morning, everyone. As Darryl indicated, we were pleased with our risk performance this quarter, where we saw continued improvement in most of our key risk metrics from our strong first quarter results.

In terms of credit performance, both impaired and performing loan loss provisions, showed a third consecutive quarter of improvement, underscoring our cautious optimism that we are turning the corner on the financial stress from the pandemic.

Starting on Slide 25, the total provision for credit losses was $60 million or 5 basis points, down from $156 million or 14 basis points last quarter. Impaired provisions for the quarter were $155 million or 13 basis points, down from $215 million and 19 basis points in the first quarter and well below pre-COVID levels. The strong impaired loan loss performance is due to the low rate of new impaired formations while recoveries were consistent with prior quarters. We are pleased with the results, but do expect impaired provisions to return to more normal levels over time.

We recognized a release on performing loans of $95 million this quarter, which was the result of positive credit migration and an improving economic outlook. We now have approximately $2.8 billion of performing loan allowances. And based on our expectation of loan impairment and provisions, we continue to remain comfortable that our allowance provides adequate provisioning against loan losses in the coming year.

Turning to the impaired loan credit performance in the operating groups, we saw unusually low loss provisions in several of our business segments. In Canadian P&C, consumer loan losses were $100 million, up 2 basis points from low levels in the prior quarter. In U.S. P&C, consumer losses were $3 million, down significantly from last quarter. In addition, delinquency rates improved in both Canada and the United States.

In our commercial and corporate businesses, we have seen similarly encouraging credit performance, driven largely by our U.S. segment where we posted a third quarter of low impaired provisions. In U.S. commercial, we reported impaired loan provisions of $3 million. The decline in provisions was driven by very low formations this quarter, very little new reservations and modest recoveries. Canadian commercial also had good credit performance this quarter with $54 million of impaired loan losses, down from $58 million in the prior quarter.

Our Capital Markets business had excellent credit performance this quarter with a net recovery of $6 million, down significantly from the Q1 provision of $45 million. The decline was driven by zero impaired formations this quarter in our capital markets business.

On Slide 27, impaired formations at $425 million declined 36% from last quarter and are at the lowest levels in recent years. We saw significant improvements in some sectors that have been particularly stressed over the past year, such as oil and gas, where we recorded zero formations this quarter and in our sectors highly impacted by COVID, where formations were quite modest.

Gross impaired loans declined by $442 million to 65 basis points, continuing the trend towards pre-COVID levels that we've seen over the past few quarters.

On Slide 29, we provide an overview of those sectors where we have seen COVID-related impacts on credit quality. These segments make up less than 5% of our portfolio and notwithstanding the stress, our impaired loan losses across these segments have been quite modest relative to formations to date, reflecting strong origination practices and loan structures. We continue to closely monitor these segments, particularly given the prolonged lockdowns in Canada.

And finally, as you see on Slide 30, there were no trading loss days this quarter.

In terms of the outlook, we remain cautiously optimistic given the solid credit performance we've seen in the last 3 quarters, and we expect credit losses through fiscal 2021 to remain manageable. In terms of the performing provision, while uncertainty remains in terms of the future path of the pandemic, assuming vaccination progresses in our key markets and we continue to see a reduction in COVID cases, we would expect further releases from our performing provision in the coming quarters.

In terms of impaired loan losses, given the strength of current credit conditions and the near-term economic outlook, we may see the next few quarters continue with low credit losses. Looking into fiscal 2022, our expectation is that impaired loan losses will normalize and average in the range of low 20s in terms of basis points.

I will now turn the call back to the operator for the question-and-answer portion of this call.

QUESTIONS AND ANSWERS

Ebrahim Poonawala - *BofA Securities*
I guess, just the first question around commercial loan growth. I heard you -- I think both Darryl and Tayfun, talk about expectations for a pickup. You did actually have commercial loan growth up quarter-over-quarter, both in Canada and the U.S. Just talk to us in terms of what we are hearing from the U.S. banks, there's a lot of liquidity impact also weighing on borrower demand. So give us a sense of timing of -- in both regions when you see commercial loan growth picking up? And do you expect Canada to be stronger than the U.S. as we see a pickup in loan demand?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

So Ebrahim, it's Dave Casper. Let me try to give you a sense. So when we talk to our clients, and this would be pretty similar on both sides of the border, demand for their products is really quite strong. And we're seeing that really across all of our industries and regions. Our pipelines are up across the board. They're back to pre-pandemic levels. We continue, on both sides of the border, to add a lot of new clients. But as part of your point, many of those clients, while we give them authorizations for credit, they're really not borrowing today. So they come over, -- we get their operating business, but they're not borrowing today.

The M&A activity continues to be high. And I should say, enthusiasm on both sides of the border for growth continues to be high. The headwinds, which Darryl and Tayfun have both covered are real, and those are that inventory pipelines are basically clogged across the borders now. Labor issues are real. They really are real, and there are very few of our clients that aren't having issues there. And there's product delays and there's price increases. So all of that is kind of the backdrop to -- the answer, I think, to your questions.

Loan growth, as you pointed out, was actually sequentially up both in Canada and the U.S. this quarter. And I expect it will continue to grow during the quarters, but at a modest pace. I think by the fourth quarter, we'll start to get back to loan growth as starting to see what we've seen in the past with modest increase year-over-year. I think where my enthusiasm -- last year, we were pretty optimistic that we'd have loan growth by the end of this year, and I continue to believe that. I'm more optimistic now than I ever was in terms of over the next 2 years, including the next 2 quarters.

So it's going to get better. The economy is coming back. I don't think Canada is going to be necessarily any faster than the U.S., but they're both growing. And I'm just reflecting the optimism of our clients. And I've already outlined some of the headwinds, but those will go away. So let me stop there and see if I've answered your question appropriately.

Ebrahim Poonawala - *BofA Securities*

Yes. That was helpful, Dave. And just one thing to add on to that. Like pre-pandemic, we did see BMO in the U.S. - you've talked a lot about white space and market share opportunities - should we expect you to outperform, if and when commercial loan growth for the industry rebounds, given the market share opportunities you've had maybe over the last 5 to 7 years?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

I think we will continue in the U.S. to take advantage of the white space we have, the industries we cover, the geographies that we cover that we continue to grow. And I would expect that just as we have in the past, we will be peer-leading in our loan growth over the next couple of years. And really more important than loan growth, client acquisition growth.

Ebrahim Poonawala - *BofA Securities*

Got it. And what was the PPP balance if you have that at the end of the quarter?

Dave Casper - *Bank of Montreal CEO. BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

In the U.S.?

Ebrahim Poonawala - *BofA Securities*

Yes.

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

Around $4 billion, I think.

Tayfun Tuzun - *Bank of Montreal - CFO*

Average loans are $4 billion.

Ebrahim Poonawala - *BofA Securities*

And the remaining fees tied to that, that you expect to accrue as they get forgiven?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

I think we've basically accrued about half of the fees that we've received. We've accrued about half, and the rest will come in through the next couple of quarters and into next year. I think it's around in U.S. dollars, around $100 million. Tayfun can correct me if that's not close?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes.

Paul Holden - *CIBC Capital Markets*

First, I just want to ask a quick question of clarification. Tayfun, you mentioned you expect NII to be roughly flat year-over-year. Just want to clarify if that's for the full year 2021 or the back half of the year?

Tayfun Tuzun - *Bank of Montreal - CFO*

Full year '21 compared to full year '20.

Paul Holden - *CIBC Capital Markets*

So my next question is just regarding the NIM sensitivity table you provided in the slide deck there, which is very helpful and really highlights the upside you have in the U.S. business. Just wondering to your knowledge, is there anything different about BMO's Canadian business that would perhaps make it any more or less rate-sensitive than peers domestically?

Tayfun Tuzun - *Bank of Montreal - CFO*

I don't think so. I think it's really -- I mean, the contrast that you see between the U.S. and the Canadian side is more related to the deposit sensitivities in the U.S., the picture is a bit different. But I don't think that's necessarily, to my knowledge, that there are significant differences in Canada between us and the peers. Obviously, we continue to also invest and roll both our deposits and equity on a periodic basis. And you may see some quarter-over-quarter changes in that number. It more relates to how we invest those balances.

Meny Grauman - *Scotiabank Global Banking*

Also on the subject of rate sensitivity Tayfun, you talked about how the rate sensitivity can go higher if you're able to retain the excess deposits that you've built over the pandemic. I'm just wondering how much upside is there? What's your expectation there as you look at it now?

Tayfun Tuzun - *Bank of Montreal - CFO*

So Meny, if we assume that we retain all of the balances, it's a modeling exercise basically, then the sensitivity could be 70%, 80% higher than what we are showing up here, but we don't want to do that as we expect those balances to eventually leave the banking system. So that sort of is the range that I can give you. It is a number that is quite sensitive to the assumptions around retention of those deposits.

Meny Grauman - *Scotiabank Global Banking*

That's helpful. And then maybe as a follow-up, just on the business side. If you can kind of try and highlight what are you doing on the business side to try and retain those deposits? Is there a particularly different Canada versus the U.S.? Just trying to get a sense of how you can make those deposits stickier? How realistic that is to expect that some of those deposits will stay?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

It's Dave. I'll talk a little bit about the commercial side. I think the reality is we are viewed as a pretty safe place to put excess deposits combined with a very good place to actually have your operating accounts. So during this pandemic, we benefited on both sides. We will retain more than probably what the model suggests, at least compared to what we've done in the past. We always seem to retain more. As clients need to use them for borrowing, obviously, that will come down. But we have a lot of clients that just don't borrow. And we'll keep a fair amount of money in short term and we'll retain those. What we're really doing is we're always competitive, but today, we don't have to be that competitive to keep these rates and keep these balances. And it's basically the same on both sides of the border. That would be the, in essence, the commercial strategy. Ernie has done a great job on the retail side as well.

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

Thanks, Dave. I'll take over, Meny, on the retail side. I'll start with the U.S. first and then do Canada. On the U.S. side, as you know, we've been acquiring deposits across 50 states in the U.S. and are committed to continuing to maintain good relationships and those growth engines for deposits. We've shifted our focus away - and this is a North American statement - away from the broker term CD market and have been really focusing on our customer base and on chequing and savings growth. On both sides of the border, we have been accelerating our initiatives to digitize that process, acquire more new customers for those key relationships that start with a chequing and a savings account. And you'll see that growth happening in Canada in our retail deposit share movement and as well as our continued investment in marketing campaigns for growth. So we're really pleased with those relationships and find that those deposits, as you can imagine, are sticky.

And as we see the economy open, there may be a little bit of softening as consumers start spending on both sides of the border, we'll see a decrease in those deposits. But as I've said, as we acquired more new customers and we anticipate that the surge deposits that we've acquired will be slower running off than one had imagined a few months ago. That's initially what we're seeing as the economies are slower to ramp up the consumer spending. So really a good news story on both sides of the border on the retail side.

Doug Young - *Desjardins Securities Inc.*

I guess this question is for Pat. I'm just trying to think of credit here. And I mean, -- your average coverage ratio for performing loans was, I think, around 32 basis points in fiscal '18 and fiscal '19. And what I'm trying to get at, is there any reason why you can't revert back to this level, call it, over the next few years? Has there been structural changes? Are you just going to be more conservative? Or what would be a reasonable time frame? If you're confident in your book, what would be a reasonable time frame for getting back to that level?

Pat Cronin - *Bank of Montreal - CRO*

Thanks for the question, Doug. I would say, first of all, in terms of the timing for getting down or timing of releases, it's really going to depend on primarily how we see lockdowns easing, particularly in Canada and then a commensurate reduction in stress for those borrowers that are uniquely impacted by the lockdowns. And then we'd like to see an easing of some of the health issues that are percolating and certainly in countries like India that may have a larger impact on the global economy. And then some stability in Canadian housing prices would probably be another trigger for us to start to release.

In terms of where we get back down to, it really depends a lot on the mix of the book and some things we might provision higher for than others. So it depends a lot on how some of the sectors grow as well as the product mix within the consumer business. And then I would expect us to remain slightly elevated versus our historic levels because now we obviously have a new stress event to consider when we think about what the tail of loan losses could be as we move forward. So it will take some time to go back down. My gut is probably over the course of the next 12 to 18 months, we'll see a reduction to something that's more stable, and it will probably settle slightly above where it's been pre-COVID.

Doug Young - *Desjardins Securities Inc.*

Okay. That's helpful. And then just on card fees, I mean, it was mentioned there was a non-recurring item, but I'm trying to get an idea of just the trending of card fees. And so I don't know if you can quantify what the non-recurring item was that we can kind of look at card fees, excluding that. And can you talk a bit about what you're seeing in the card business in general?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. So let me answer the fee question, and then I'll turn it over to Ernie about what she is seeing. Doug, as I said, there were 3 notable items during the quarter. Altogether, they didn't have any impact on net income. And one of them was in card fees. In terms of sort of the trend expectations, what I would suggest is that in a quarter or 2 as consumer spend activity picks up and card swipes continue to go up, we would expect to grow into this number away from the one-time impact this quarter. So that's how I would look into sort of modeling that line item.

And in terms of what Ernie is seeing already, I will turn it over to you on that topic.

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

Thanks, Tayfun, and thanks for the question, Doug. If I look at sort of card-related revenue, obviously elevated this quarter as you've mentioned, that line typically has a couple of items in there that move around. Timing of reward cost is one, the actual consumer spending that occurs through that. So as I look in the past month or so, what we're seeing is a return back to, I would say, pre-pandemic levels of spending, and it's just been a recent – in the past month or so that returning back to 2019 numbers, and that's good to see overall. We're seeing it in a couple of categories.

As you can imagine, historically, in the pandemic, you saw grocery, home reno, gardening kind of categories at their peak and above normal levels. And now what we're starting to see is a return to travel and we're seeing that across hotels, travel industry. And so that's really a good indication of what we're going to be facing in the next little while, which is as consumers are more confident about the pandemic situation, get vaccinated, we're seeing that spend grow.

So I would anticipate that we are going to be seeing stronger and strengthening consumer payment spend. I'm seeing that even now on credit card acquisition. We're really pleased with our launch of our new Visa Eclipse products, they're performing extremely well in terms of acquisition growth. It would appear that the payments business is getting back up to where it was pre-pandemic. So we're really pleased with that performance.

Gabriel Dechaine - *National Bank Financial, Inc.*

I have a quick one on the pre-payment income and then a follow-up. In Canada, do you have a -- can you tell if you have maybe more a strategy to encourage pre-payment activity? And relatedly, like what is the size of these revenues has been over the past couple of quarters?

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

It's Ernie. I'll -- I think you're referring to prepayment on mortgages, is that it?

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

Yes. Mortgage.

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

Okay. Thanks for the clarification. It's an interesting question. Obviously, consumers are taking advantage of a lower interest rate environment to refinance. We're also seeing consolidation of lending, so really looking at how do they consolidate into home equity lines. But in terms of prepayment, this will be a phenomenon that continues as we have low interest rates. Do I anticipate it to diminish? I think, over the coming months, you will see that just as more consumers have taken advantage of it, who were interested in taking advantage of prepayments have done so. And then also as we go forward, we're going to see increased spend, if I can use that terminology. And that will also be helping our overall lending growth versus the prepayment fees that you're speaking of.

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

What's the size then of these revenues over the past couple of quarters?

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

I don't have that off hand. We'll probably come back to you with that as a proportion of our NII.

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

All right. That would be great. Then for whoever, maybe Pat and business heads as well, like the inflation topic is, of course, the top of mind everywhere. How are you thinking about the numbers we've been seeing lately, both from a positive and a negative sense because it could suppress demand if people delay their decisions, in their buying decisions when prices are moving so fast and up. But it does help, I guess, from a credit risk standpoint on LTVs on what's on the books already. I'm mumbling here, but if you can give me a sense of how you're thinking about the inflationary story these days and how you're preparing for good or bad things?

Pat Cronin - *Bank of Montreal - CRO*

Sure. Maybe I'll start. It's Pat, and then I'll turn it to others. Specifically to the inflation that you're seeing in home prices, you're correct with existing homeowners, that has the effect of actually improving LTV. So that's a credit positive. We are looking, though, very carefully at existing originations. Their elevated home prices may exaggerate LTVs. And so we're taking -- our risk management practices on housing is dynamic anyway. And so through the cycle, as prices change, we adjust our practices. And we're routing more mortgages to manual adjudication particularly where we're looking at areas where we've seen rapid house price appreciation, just to make sure that we're comfortable. But ultimately, our mortgages and loans are to the borrowers' ability to pay, not the house price. And so to the extent we're satisfied with that, then we're comfortable from a risk perspective.

And then broadly, we are stress testing our loan portfolios against higher interest rates. Generally speaking, we do that anyway. As you know, for sure, for consumer, as well as commercial borrowers when we originate, we stress test against higher interest rates anyway to make sure that they can sustain the level of borrowing in the event of higher interest rates. But then we stress test the portfolio broadly. And this will evolve over time for sure. But what we're seeing right now is the stress that could be caused by inflation is definitely manageable within the earnings power.

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

Anybody else on the business growth side? Well, actually, I'll stick to, Pat, the stuff like -- are you seeing any commercial orders or the input costs are based on these -- all the commodity prices that are soaring and that might be squeezing the margins. Are you seeing any of that at all?

Dave Casper - *Bank of Montreal - CEO, BMO Harris Bank N.A. and Group Head, N.A. Commercial Banking*

Well, we're definitely seeing some input costs across the board at this point with, I don't think, any exceptions. Most of this is getting passed on, and it's expected, which is clearly, if this continues, we'll have some inflationary pressures. But right now, our customers need to get the inventory and they're paying for it. And it will likely get passed on. I don't see big margin pressures.

Pat Cronin - *Bank of Montreal - CRO*

Maybe just one follow-on to that. Certainly, from a risk perspective, we're not seeing it driving wide-scale stress in the portfolio. You would normally start to see that show up in negative credit migration. And in fact, for the second quarter in a row, we've had some pretty healthy positive credit migration across the wholesale book. So, it's obviously, as Dave said, it's not immune, but we're not seeing it show up broad-based in terms of negative migration.

Lemar Persaud - *Cormark Securities Inc.*

My first question is on the interest rate sensitivity disclosure. First of all, thanks for providing that. I think it's useful. I'm just wondering if you could just answer just a high-level question. How much could the sensitivities change from quarter-to-quarter? I guess where I'm going with this is that one of the big downfalls on the structural interest rate sensitivity tables that all the banks provide in their annual reports and MD&A is that it changes so much from quarter-to-quarter, and it's only really relevant for a specific point in time. So, the sensitivity -- if this interest rate sensitivity table is subject to similar levels of volatility, it becomes a little bit less useful for me. I'm just wondering if you could offer some comments on that.

Tayfun Tuzun - *Bank of Montreal - CFO*

Very good question. These are clearly as of the date that they are run and they are published. There will be quarter-over-quarter changes and changes in this number, depending upon the actions that we would be taking during that quarter. So that clearly will have an impact on the sensitivity. At points in time, we may decide to invest a larger portion of the liquidity that we are in, which takes away the remaining sensitivity on those balances. We may have different hedging policies, depending upon our perspectives, that we execute during the quarter.

The reason why we decided to give you the numbers without necessarily adding deposit liquidity, for example, that I mentioned, which would have shown higher sensitivities, is partially due to that reason because we did not want to -- it sort of creates challenges in comparing quarter-over-quarter numbers. But there will be some changes depending upon our rate management actions and also movement in the yield curve that occurs. So these are natural factors, not necessarily related to any structural changes in sort of the underlying unhedged balance sheet.

Lemar Persaud - *Cormark Securities Inc.*

All right. And then just maybe if I could squeeze another one in here. I'm just wondering if I can get some thoughts on the impact of the more stringent qualifying rates for domestic mortgages. Do you think that some of the really strong growth we saw this quarter just being pulled forward to get ahead of the higher qualifying rates, and then we could see a bit of a slowdown in coming quarters? Maybe just some thoughts on that.

Ernie Johannson - *Bank of Montreal - Group Head, N.A. Personal & Business Banking*

Yes, it's Ernie. I'll take that one. There will be some impact as a result of that increase, what we call the stress test, as you said. The impact will be probably about 5% to 10% max from the perspective of impacted borrowers. That said, there are ways in which they can obviously find a lower-priced house, being able to either find more equity somewhere from parents and gifting and all those sorts of good things.

So it's very difficult to understand what the full impact will be. They may actually just end up, these consumers, going to a lower-priced house in that case. So overall, there will be some sort of moderation - to the extent of being able to say what exactly that's going to be, it's difficult to say. But we can assume, just given what we're seeing right now in kind of housing prices and sales, that there will be some moderation, that would be our expectation over the next little while, but it will still remain a fairly robust mortgage market in Canada, for sure, over the next little while.

Mario Mendonca - *TD Securities*

If we could go back to your guidance on net interest income for the year being flat given the comments on -- and the apparent momentum in your loans, commercial and also on the retail side, I was a little surprised by that. It was also sort of surprising in the context of the move we've seen in the U.S. 5-year and the Canadian 5-year in the quarter. So maybe what I'm getting at here is assuming the loan growth remains good and perhaps even accelerates, as Dave suggested, where will the margins come in? Because that's the only other explanation. Are you pointing us to lower margins in Canada and the U.S. or lower margins outside of the domestic P&C franchise?

Tayfun Tuzun - *Bank of Montreal - CFO*

Again, another good question. If you go back to Slide 16, we are expecting NIM to be relatively flat. And that's partially as a result of the right side of that slide where the reinvestment yields currently are still below those that are coming off from prior investments of either our equity rolls or deposit rolls. So that still is a phenomenon that continues to put some pressure on NIMs. In terms of year-over-year comparisons, in Canada, for example, although we are benefiting from mortgage growth, which is elevating our average loans, relative to past years, obviously, that's -- we are not necessarily seeing much growth in credit cards, which has higher spreads. So that's also playing a role, both in the U.S. as well as in Canada.

The composition of the loan portfolio is slightly changing until personal borrowing, including credit cards, picks up, which has higher spreads. So there's nothing really unique about the guidance. And if we end up seeing stronger average loan growth in the second half of the year than what we are anticipating, then you would see a pickup in NII. So I think in general, the guidance is pretty much in line with both what's happening on NIM as well as in sort of the composition of the loan portfolio.

Mario Mendonca - *TD Securities*

Okay. Perhaps not to put too fine a point on it. Even if the domestic -- or sorry, rather, if the total bank margin is essentially just flat, going forward for the remainder of this year, I can't see how BMO doesn't grow the NII. I just -- the numbers don't -- they just don't add up. NII grows year-over-year if your margin is flat. I mean I don't know it's just sort of a mathematical truism. So maybe it's something we could take off-line because I just don't -- I don't follow your guidance very well?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. It probably goes back to sort of the yield on earning assets. That is changing a little bit. But again, we can discuss -- again, we're giving you a guidance as we see it today, but is there an upside? There may be some upside to the guidance depending upon how the second half moves.

Mario Mendonca - *TD Securities*

Okay. Maybe a different type of question then. The FX fee just looked really good this quarter. Was there anything special in there? Or was that -- I'm not referring to FX trading, I'm talking about the FX fees, non-trading. They were just very good this quarter. Was that just really good client activity in the quarter? Or was there something else going on?

Tayfun Tuzun - *Bank of Montreal - CFO*

There's nothing unique in that line item in terms of any quarterly one-time impacts, it's just client activity.

Scott Chan - *Canaccord Genuity Corp.*

So on the Capital Markets side, obviously, very solid in the quarter. Could you offer us any kind of guidance that you see over the next few quarters in terms of DCM, ECM or M&A advisory activity?

Dan Barclay - *Bank of Montreal - Group Head, BMO Capital Markets*

Well, thanks for the question. Obviously, very satisfied with the quarter. Great to see the investments that we've made and the portfolio adjustments really start to pay off. I think it also is a demonstration, the diversification of our platform, both in terms of product, markets and clients. As we look forward, I think we'll continue to see the benefit of the investments we made across the platform, particularly in the U.S., where you've seen the strong results we've had year-to-date. We expect those to continue on as we go., Our pipelines remain very strong. M&A, in particular, has been building and growing. We had a very strong quarter in equities and leveraged finance.

I think M&A activity continues to pick up over the balance of the year. We'll continue to see strong revenue growth there. I think we'll also benefit as we look forward to the portfolio choices we've made in terms of what we've been doing, driving our cost structure down. You saw our efficiency ratio is less than 55% year-to-date. And I think we'll continue on that benefit. And then I think we'll also continue to have a benefit in the strong credit environment that we've experienced and that's going to continue on. So all in all, strong performance we expect coming into the balance of the year.

Scott Chan - *Canaccord Genuity Corp.*

Great. And maybe just lastly for Darryl. Just on the capital side. I've got to ask you, the CET1 ratio at 13%, pro forma higher with the asset management sales. So assuming that OSFI does lift restrictions later this year. At this point today, what are your kind of capital priorities, including M&A?

Darryl White - *Bank of Montreal - CEO*

Thanks for the question. Short story, unchanged. The first use of our capital is for our clients and devoting it to their benefit and their growth. I think we've shown that in the past in expanding environments where we've been able to grow and take that white space that we talked about earlier in the call, we've been able to do that at increasingly profitable returns. So that would be priority One. And then you're into the tree on deploying it to dividend increases versus buybacks. I'm not going to get into the speculative game of when that will be possible. That will be to the regulator's decision. But when it is, you would expect us to be active there, absent being active on the M&A front.

And on the M&A front, I'll go back to a framing I think I've given before. I talk about this in terms of tools and discipline. As far as tools are concerned, without question, we've got lots of them. We've got excess capital. We've got operating momentum. We've got a great team, and we've got good muscle, I would say, in terms of the success that we've had and the acquisitions we've made. So tools are great. But they don't come at the expense of discipline. And discipline for us is strategic, it's cultural and it's financial. And I think I've said before, you have to be careful not to swing at every pitch. There are lots of pitches, but lots of them are in the dirt. So if you see us active, it will be because we landed something that meets both the discipline and the tools. And if you see us not active, it will be because we haven't found something that goes over the disciplined bar. So I'll leave it at that.

Darryl White - *Bank of Montreal - CEO*

Thank you, all of you for your question. I'm going to wrap up quickly here with 4 key summary themes. Number one, our results for the first half of the year, as I said earlier, are clearly very strong with our ROE, our EPS growth and our operating leverage, all above our mid-term targets. Number two, we're not stopping there. We're moving the bar significantly higher on our expense and our efficiency commitments and we have strategies in place to do more. Number three, our credit quality will remain a differentiator for us as it has for decades. And number four, our purpose-driven strategy is delivering consistent performance, the strong momentum and the clear potential across all of our businesses, the advantaged business mix is ready for more, especially with an accelerating economic backdrop that we're driving into.

So I'm highly confident that as the economies reopen, we're going to continue to accelerate through the next year and beyond.

Thank you all for participating in this morning's call. We look forward to speaking to you again in August.
