Scotiabank – 2014 Global Financial Summit
September 3, 2014

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Assumptions about the level of default and losses on default were material factors we considered when establishing our expectations regarding the future performance of the transactions into which our credit protection vehicle has entered. Among the key assumptions were that the level of default and losses on default will be consistent with historical experience. Material factors that were taken into account when establishing our expectations regarding the future risk of credit losses in our credit protection vehicle and risk of loss to Bank of Montreal included industry diversification in the portfolio, initial credit quality by portfolio, the first-loss protection incorporated into the structure and the hedges into which Bank of Montreal has entered.

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

Sumit Malhotra - *Scotiabank - Analyst*

Okay. We will keep rolling right along. And our next guest this morning is Mr. Bill Downe, CEO of the BMO Financial Group. Unlike many of the new chief executives we have this morning, Bill has been CEO of the bank since 2007. He has spent 31 years with the bank in a series of progressively senior roles, including time within BMO Nesbitt Burns, the US division, and of course, BMO Canada.

So, without further ado, Mr. Downe is already on the stage. And I will just tick the box here and say that Bill's comments may include forward-looking statements. Actual results could differ materially from forecasts, projections, or conclusions in these statements. And everyone can find additional details in the public filings of the BMO Financial Group.

I'll have it committed to memory soon.

Bill Downe - BMO Financial Group - CEO

Hi, Sumit. Nice to see you.

Sumit Malhotra - *Scotiabank - Analyst*

Good to see you. Thanks for your time.

Bill Downe - BMO Financial Group - CEO

Pleasure to be here.

Sumit Malhotra - *Scotiabank - Analyst*

So, as I mentioned in that opening, we do have a number of new chief executives this morning presenting to us. Obviously, you're now one of the veterans or longer serving members of the group.

But, I don't think that changes the opening question, which has been, as you look at the outlook for the bank in the medium term, not only as an executive, but as a shareholder as with many of the people in the room today, what do you see as being the greatest challenges facing the bank from delivering the strong returns that it's consistently provided for a number of years?

And conversely, what are the opportunities that you're most excited about as a shareholder of this institution?

Bill Downe - BMO Financial Group - CEO

Okay. Well, thank you for the opening question. It's nice to start with challenges. One quick observation before I answer your question, this is your first conference here, too.

Sumit Malhotra - *Scotiabank - Analyst*

It is.

Bill Downe - BMO Financial Group - CEO

It's an opportunity to do it a new way. And I'm sure none of the other panelists would appreciate this. But, this conference, historically coming right after Labor Day, was always marked by a formal presentation. And we all thank you for turning it into a Q&A because we didn't spend Saturday, Sunday, and Monday writing out remarks, although I must say I spent a good portion of the weekend trying to figure out what it was you were going to ask. And I'm not sure what the tradeoff in labor was. But, anyway, welcome to you in your role. Let me reciprocate that. And then I'll move to the question of challenges.

When you think about challenges in any business, or industry, and when I specifically think about ours as a Canadian-based bank, I think you have to do it in the context of competitive advantage, where you think competitive advantage lies because I think that's the starting point for approaching challenge.

And one of the reflections I have is that, for our bank, a number of things have changed very significantly in terms of competitive advantage. If you go back to 2004, we were the 14th largest bank in North America by capitalization. And we're now number nine.

And what's significant about that is it makes us a DSIB, a significant institution in Canada and the United States, as well as having, on a relative basis, a much stronger position in a broader competitive marketplace.

In the last five years, we've doubled the net income of the bank. And the book value per share has increased from around $31 to $47 a share. So coming out of a period of great dislocation in markets, the value of a share of the bank has been materially increased on a book basis, which is really, I think, significant. And I know you're going to want to talk a little bit about capital later.

And then just the momentum of the operating businesses, as I look across the bank, year to date, revenues are up 9%. EPS is up 8%. But, in the Canadian business, net income after tax is up 10%. And we have 2% operating leverage.

So, when you look at the competitive landscape and think about challenge, I think your question really goes to -- what's the challenge, and in that challenge, where's the opportunity?

And there are two big areas that I think, as an investor in bank stock, I would consider to be critical, and certainly our management team is focused on. The first one is simply the interconnectedness of markets and the globalization of the financial world. And this had a profound effect on the Great Recession. It created a multiplier.

And in a similar way, it's created a bit of a multiplier in the post-recession reaction so that the complexity of regulation and supervision in multiple jurisdictions, which is designed in the end I think to take risk out of the system, requires much better information systems, the ability to exchange information, to see movements between counterparties and across markets in a way that is way more transparent than has historically been a requirement.

And on one level, it's put a big burden on institutions to reinvest in the technology to do this kind of analysis and to be able to share data. But, I would say, for us, having come through the process of Basel all the way through being AIRB compliant, so imposing a B2 framework on both our US and Canadian operations, getting early to a clear view on Basel 3, and at the same time, being a CCAR bank in the United States -- we're unique in that regard -- has allowed us to see forward, if you want, over the next hill where these two things come together because they ultimately do. And they will with the regulations in Europe and elsewhere.

So, I think being able to pull together, if you're going to operate beyond a single regime, being able to pull together information, understand how the interrelation between markets and your businesses is reflected in potential earnings volatility and being able to share that, both with investors and with supervisors. I think it's a big undertaking for any institution. On the other side of that, there's a great deal more knowledge about how the business works.

The second area that clearly is on everyone in our industry's mind and certainly we're spending time on is simply the consequences of digitization. And once again, I think we've benefited enormously from recent activities in our institution. The process of integrating another bank really accelerated some of the streamlining of our technology to allow us to be able to deal in a more mobile digitized world.

And in that time period, we've materially increased the face of the bank to the virtual world. Public Websites, in terms of usability now, and our mobile app in Canada is number one. And I think what's striking about that is we reduced features and focused on simplification. And we're seeing really dramatic growth in account sign-ups in the mobile world, up 25% in a quarter. Now, that's the kind of growth rate we're seeing and then activation or active utilization up at even higher levels.

So, I think those two big areas are the most demanding for us. They're the center of our focus. And it's really putting pressure on the talent strategy of the institution because you need flexible employees who are capable of responding to an environment that is constantly innovating. We need employees that are very sensitive to the societal expectations that are showing up both in regulation and in commentary all the time. And that's the whole notion of fairness, which I think permeates the relationship we have with our customers.

And then finally, just the push of consumerism, the expectations that individuals have, whether they're acting for themselves or acting as officers of a company we're doing business with for an immediate response, for precision, and a customer-friendly face, not a bureaucratic or institutional face. So, those are big challenges for organizations that have 45,000 or 50,000 employees and balance sheets of $550 billion. But, out of that comes opportunity.

Sumit Malhotra - *Scotiabank - Analyst*

Absolutely. And let's go into one of those opportunities that you identified a few years ago and seems to be working very well for the bank right now. And that's the focus on both sides of the border more so on the commercial borrower. And maybe we lead off with the US, where -- and we'll do a commercial versus consumer here in a moment. But, the commercial loan growth of the bank for BMO Harris has been quite sizable. It's been stronger than industry peers and regional peers for the most part.

I think a two-parter would be: A) what do you attribute this stronger-than-market growth to, and B) it seems like there may be more to come because loan utilization rates, at least from some of the data I've seen, are only starting to move for the industry as a whole. So, maybe a little bit of color on what's driven commercial, and are we just at the start of what could be a long-tail process?

Bill Downe - BMO Financial Group - CEO

Well, commercial banking, Sumit, is a business that you can't move in and move out of. If you don't have a long-term commitment, you don't have a workforce that has judgment experience and is trusted by the customer base.

And what we've seen over the cycles, and I can go back in my own memory to the late 1970s, is that the reputation of the bank for being consistent through the cycle has endured. And it's always been the case that, when valuations become a little heady, we do suffer market share contraction because there's the view that we take a conservative view in the long run.

But, that's served us very well in recoveries. And it's really the combination of an in-place workforce, seasoned bankers on both sides of the border, who really understand the specialized industry segments that they cover. And it's a very hard workforce to replace. And it works hand in glove with the credit risk management capability that is quite decentralized and quite close to the local markets.

So, when you have a recovery, you have the twin benefits of underwriting to a consistent standard, which makes it appear that you're more comfortable lending than many of your competitors immediately in the aftermath of a big downturn, gives you a great deal of confidence in your ability to grow share in that time period. And of course, you have a stable workforce. So, you're not in the process of trying to recruit in the hopes that the people you recruit will bring customers with them because you really have a great deal of difficulty judging that quality if you have no history.

So, that's worked to our favor on both sides of the border. And I think it was masked for most of 2011, 2012, and 2013 because we were running off categories of assets that we from the outset said didn't fit with the Bank of Montreal's underwriting framework in the long run. Many of those were high-quality assets, but not suited to our style of lending and banking. And so, I think that really to some extent muted the balance sheet growth that was happening underneath. So, we've seen strong double-digit C&I growth for five years.

And to your point about utilization, utilization rates still are quite low. I would say that one of the reasons why our commercial client base did well going into the downturn is they had anticipated a little bit. And they had been paying down the balances. So, we saw declining utilization rates, more dry powder, and people preserving their revolvers.

And I think you can look across categories of the portfolio. And the utilization rates range from 20% to 60%, depending on the category. But, I think our consolidated rate in the US is around 32%, which is very low by historic standards. But, I think the formation of new undrawn commitments has also been very strong. So, there's an anticipation of a capital investment cycle coming. And I think that's where I think there's some positive news for the future.

And we're seeing upticks in utilization I think in the last quarter, seven-tenths of a percent increase in utilization. So, I would say this is really the beginning of that capital expansion program.

Sumit Malhotra - *Scotiabank - Analyst*

The other side of the book in the US is obviously the consumer portfolio, where I think trends have been more mixed back to more of a flattish number on a year-over-year. This is where I lean on your time with the Federal Reserve or your experience with the Federal Reserve.

The US economy has been an enigma in 2014. On many measures, it appears things are improving significantly, most notably employment. At the same time, the 10-year treasury, if that's the economic indicator we most trust, is down 60 basis points from the start of the year.

So, bigger picture, but I certainly appreciate your views on this, US economy, housing market, health of the consumer, are you expecting, particularly for your consumer loan book, these factors are going to accelerate, or is it still going to be a waiting game as far as the consumer is concerned in the US?

Bill Downe - BMO Financial Group - CEO

Well, the story of the US consumer is often presented as a bad-news story. I personally think it's a good-news story. If you just look at consumer debt levels, they're down 8% since 2008. So, the balance sheet of the consumer has improved dramatically.

The number of homeowners that are in a position where they have a mortgage that's greater than the value of their home has been falling. I look at home price statistics, listing statistics every month across different parts of our market, different zip codes. And it has been uneven, and certainly in the State of Illinois, there's more room to go than in some other jurisdictions, simply because it has been a little slower in the recovery.

But, the health of the consumer balance sheet, on one hand, is not reflected in consumer confidence on the other. So, when you look at January, February, March, April, there is very pessimistic financial press.

And I think we underestimate the sophistication of the average consumer. They do watch financial news on television, whether they're of the left or the right. They read the financial section. They think about retirement. And they think about saving and investing. And they're very savvy. And right now, their confidence is still limited by the fact that the headlines have a tendency to exaggerate the potential of catastrophe.

So, we're seeing -- what we're seeing in consumer behavior is reflected in the mortgage activity. In 2013, it was all refi. The refi, you get to the end of the refi potential, and the real opportunity is going to come in household formation, so family formation, new household formation, the arrival of new children, which pushes a requirement for a bigger apartment or a small house or a larger house. And that has been very slow to develop simply because of the apprehension I think people have towards debt.

And what we do see is people coming to the house purchase decision with a great deal more equity, the notion of I don't want to start with a maximum amount of debt. I want to start with a very significant amount of equity in my home. And unlike Canada, there hasn't really been a reflection of the low cost of money in people's enthusiasm for housing. You'd think it would, but I think that's just a reflection of conservatism on their side.

So, I don't want to put too much burden on the people in the business, in the retail business in the United States to produce a rapid growth in two or three quarters because it is tied to the ultimate uptick in housing.

But, when you see new home construction pick up, and I'm confident that it's imminent, simply because of supply and demand. The supply now is not sufficient to meet demand. There's also going to be a multiplier effect because new homes stimulate the purchase of furnishings, carpet, appliances. And that stimulates the manufacturing economy. And I think that will have a salutary effect on employment.

The only place we've seen consumers feel comfortable borrowing and spending has been in auto finance. And I think that's a reflection of more people getting to work and needing to get to work. And that's really the principle purpose that an automobile serves.

Sumit Malhotra - *Scotiabank - Analyst*

Let's move to capital and the potential for capital deployment. You had an answer to me on the call, which I thought was pretty appropriate in that, on two occasions now, we've proven very adept at rebuilding capital after acquisitions. And I'll say it from my seat, faster than I expected after both M&I and F&C.

So, now that the capital position is back towards the higher end of the group, how would you prioritize the deployment strategy of the bank? And I know organic growth -- and I don't even know if you consider dividends to be capital or to be more a reflection of earnings. But, specifically, when it comes to capital deployment, the bank has had a dual acquisition focus. There's been the US P&C. And there's been the global wealth management. Your thoughts on where the deployment for the bank goes in the interim.

Bill Downe - BMO Financial Group - CEO

Well, the management of capital is a tool. And managed properly, it creates the opportunity for growth that shareholders are looking for. But, when you take advantage of an acquisition opportunity, in my view, you have to reprioritize where you're going to have growth in the corporation temporarily because, when you rebuild capital rapidly, you regain flexibility.

And the flexibility is critically important because you really can't predict quarter to quarter as accurately as you might want to believe you could what the impact of growth in a segment of the portfolio may be in the formation of risk-weighted assets.

And the range has been moving up over the last decade, but not so much. I presented to the Fed conference in the United States in May. There was about 350 professionals of the Federal Reserve when I talked about the difference between capital in 2004 and capital in 2014, it was very interesting when you matched the old B2 Tier 1 Ratio to the CET1 Ratio, how they paralleled each other so closely.

But, in truth, we've increased the capital in our system by about 40%. And I did say on the most recent call that -- reiterated on the recent call that being in the 9.5% to 10% range on B3 CET1 is a good place to be. When you're at the high end of that range, you have flexibility. And when you're at the low end of that range, you really don't have very much flexibility because the market's looking at your capital as closely as anyone else is. And your shareholders are looking at your capital.

So, we've put a big premium on the rapid rebuild, not because anyone specifically told us, but we wanted to be in control of our own destiny. And that really feeds into your question about, how do you see the application of that capital? Well, organic growth does have the ability to absorb capital. And immediately after rebuild, there is an opportunity to expand the balance sheet a little bit. And so, you get some absorption capability there.

The challenge with acquisitions is always the extent to which, in our industry, acquisitions give rise to a lot of goodwill. And goodwill is money you spend, and then it ends up as a subtraction from your regulatory capital. So I think it's a real balancing act when you want to maximize the value of the firm to continue to make acquisitions that are accretive.

And in some ways, perhaps it keeps the affordability of acquisitions at a more sensible place, this impact of regulatory capital. Only well-capitalized firms can be acquirers. But, you have to constantly look at that relationship between goodwill and the subtraction from regulatory capital.

So, we do think there are opportunities to make intelligent acquisitions in the context of a growing portfolio of businesses. And I think our track record in over a decade of making acquisitions at sensible prices, making them accretive quickly, restoring capital quickly, and being very respectful of the integration focus required to make them productive and accretive. You can't just acquire things and hope that, on their own, they'll be productive.

The philosophy around return of capital, I think we've been very clear about that. We've reduced the target payout range for the dividend in the last four or five years. The reason why we did that is, when you look at the full cycle now, you want to be in a position where your payout ratio doesn't go too high.

And then we're the longest dividend-paying company in Canada, over 180 years, probably the longest in North America. The dividend does matter. And stability of the dividend does matter. And we have to be respectful of that.

So, I think having your dividend increase in line with your earnings, then the focus is on earnings growth, not on the dividend because the shareholders know what will follow.

And with respect to share buybacks, I've always been of the view that many firms are tempted to buy back when the stock is reflecting the value of the firm. And they're afraid to buy back stock when they believe it grossly understates the value of the firm. Our track record there has been we've been diligent in buying back stock at times when we had a surplus of capital and we didn't want to make an acquisition simply to make an acquisition. We think that's been extremely accretive for shareholders and it's a philosophy we'll continue to adhere to.

Sumit Malhotra - *Scotiabank - Analyst*

Last one and I don't want to close without asking about this segment because it's been so strong over the past year. And that's obviously the Canadian P&C division. I think most of us in this room have a very good idea what's happening on the revenue side with some of the moving parts.

I think the operating leverage that Cam Fowler and his team have delivered has been quite impressive. And this maybe leads back to your comments earlier about digitization, technology. How do you balance the desire of the market to see consistent positive operating leverage with the investment spend that needs to go into this business on a variety of different areas? And I will close with that one for you.

Bill Downe - BMO Financial Group - CEO

I think it's a decade-long story in truth, Sumit. If I think about where we were a decade ago, we're a much better bank today than we were in Canada. The quality of our distribution network, both the quality of our branches and the virtual network, is dramatically improved.

During the early years of that transformation, we were criticized because we were spending very heavily. And revenue was coming along. But, it was coming along in line with that expenditure with a time delay of 18 months or 24 months or 36 months.

And when you have good performance and you start to do it consistently, there's a temptation to say, well, what did you do in the last quarter that affected earnings? And what you did eight quarters ago, 10 quarters ago, 12 quarters ago is reflected in today's earnings. And the investment and change that we're making in the business today I think is going to pay off eight quarters, 12 quarters from now.

So, I think the confidence that management of the personal and commercial banking business has is they've gotten in a rhythm where we continue to invest in the businesses, but the investment in previous periods is paying off.

And the evolution of whether it's the branch distribution footprint, what it looks like, what the retail experience is like, and how it integrates with whether it's online or mobile, whatever device you want to have, there are two benefits to it that flow from being obsessed with your customer.

One is that, if we can take work out of a transaction for the bank, almost by definition, we take work out of the transaction for our customers. So, the usability of the products and the services of the bank is going up consecutively period after period after period. And that's showing up in customer loyalty, customer satisfaction. And I don't think it's a coincidence it's showing up in enthusiasm on the part of our employees, too. Doing work is a lot more satisfying when you can feel the outcome.

So, there's a virtuous circle in investment. And I think we're seeing the payoff in that. And then information and the use of information has allowed us to simplify the management organization. And I think there's been some real benefits to just a consistent process of delayering, reducing the number of management people in the head office and increasing the number of leaders in the market.

So, I think this is a good story. I think it's a long-term story. And it's been -- as I said, it's been a decade in development.

Sumit Malhotra - *Scotiabank - Analyst*

Well, congratulations. And thank you very much for your time.

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Bill Downe - BMO Financial Group - CEO

Thanks for having me at your conference.

Sumit Malhotra - *Scotiabank - Analyst*

Thanks for the kind words. We'll talk soon.