BMO Financial Group

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CORPORATE PARTICIPANTS

Tom Flynn *Bank of Montreal – EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Peter Routledge *National Bank Financial - Analyst*

PRESENTATION

Peter Routledge *- National Bank Financial - Analyst*

To my right, we have Tom Flynn. Tom is Executive Vice President and Chief Financial Officer of Bank of Montreal. He was appointed to his current position about one year ago in March 2011.

He's been with BMO Financial Group since 1992, worked in the Investment Banking group and then for a time was Treasurer and Chief Risk Officer. He's also Chair of the Board of Holland Bloorview Kids Rehabilitation Hospital and has an MBA from Ivey School of Business at the University of Western Ontario. Tom, thanks for joining.

Tom, just to kick off, what key messages would you like folks to take away from today's session?

Tom Flynn *- Bank of Montreal - EVP & CFO*

Thank you, Peter. It's good to be here in Montreal. I'll make a few brief comments and leave with three key messages that we think make BMO an attractive investment right now.

The first is that we feel good about our business in the United States. And we do have a larger US business than the average of the other Canadian banks. We did a large acquisition that closed in the middle of last year, and that acquisition is going better than expected on the synergy side. From an income perspective, we're accretive basically in the first quarter versus expecting to be accretive at the beginning of the second year.

We feel good about the retail business, which with that acquisition is twice as big as it was and far more competitive; feel good about the markets that we're operating in, which are doing well from an economic perspective and are large. The Midwest markets that we operate in have a GDP that's actually bigger than the Canadian GDP and an unemployment rate lower than the overall US growth rate. So, the economy's doing well.

And then lastly in the US, our capital market business, where we've been investing, we think has upside as the investments that we've made in people start to pay off in a better environment.

The second message is that, with the acquisition of M&I and lower growth in our capital market business, our business mix is now skewed towards the retail side. It's more than 75% retail; In Q1, it was 80% retail from a revenue perspective, and the shift that we've done over the last four to five years has been deliberate, and we feel good about it. Canadian retail business, we think will do well, we have invested in it, and we're overweight in commercial, which we think is a good place to be at this point in the cycle.

And the last point would be that we started the year with a good first quarter. Net income was $1.1 billion, adjusted income $972 million, which was up 19% from last year. EPS was up 18% from last year at $1.42. And those strong results reflect the business is doing well executing on their strategy.

And with that, happy to take questions.

Peter Routledge *- National Bank Financial - Analyst*

All right. I'm going to start with just talking about the Canadian retail business. And Bank of Montreal's 2.99% mortgage product is a popular one and so popular in fact your competitors have been commenting on it today and yesterday and used words like it's a hypercompetitive market and that there are low to negligible margins in the Canadian mortgage business and cite the BMO product as illustrative of that.

And I suspect that, if you were to peel back the layers on that product, it might be an overstatement, at least in your view. So, maybe give us your thoughts on the 2.99% product, what it is and what it isn't.

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Sure. So, I think I'd start by saying that, as we see it, it's not a 2.99% product, even though I take it that some of our competitors have characterized it in that way. We see it as a good product for people who have a mortgage that they want to pay off in a quicker period of time. And the product has a rate of 2.99% and an amortization period of 25 years, which is shorter than the normal amortization period.

And so, it's a great product for someone who has the capacity to pay their mortgage down more quickly, which is a good thing from a personal financial perspective, which is an important thing, given the overall state of Canadian consumer finances.

We're actually quite happy that we've got people's attention, and we're happy to have people talking up our product, and we're happy to have the volumes that we see coming through the door with the product. So, the product to me has gotten more attention than expected, which has been a positive thing. And we're encouraged by the volumes that we see.

The product is absolutely profitable. And it's nicely profitable. And we're comfortable with the financial returns. It was offered for a fixed period of time. So, we launched it three weeks ago when we issued a press release last night, saying that the product was being removed from the market on schedule. So, it was a short-time offer that was out there to stimulate some interest, stimulate some demand, stimulate some traffic, and we think we succeeded in doing that.

And one of the things about the product is that, although the rate is low, the payments are actually relatively high because of the short amortization period. So, the product is a great product for someone who's looking to refinance a mortgage. And we have a mortgage share that's less than one-fifth of the market.

And so, it's been a good product in terms of generating interest from people who have mortgages that are up for renewal from other banks. And it's a nice product for someone who has a capacity to handle the higher amortization.

Peter Routledge ***- National Bank Financial - Analyst***

Are there LTV limits on it?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Nothing unusual, no.

Peter Routledge ***- National Bank Financial - Analyst***

So, you would just walk in and either buy CMHC insurance or you have more than 20% down. Is that how?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Correct. So, it's no different from a regular mortgage product in that regard.

Peter Routledge *- National Bank Financial - Analyst*

Okay. And I'm wondering. To get the product, you've got to walk into a branch or?

Tom Flynn *- Bank of Montreal - EVP & CFO*

Ultimately, you would have to walk into a branch. I do know that our call centers have been active talking to people about the product. But, ultimately, you would need to walk into a branch.

Peter Routledge *- National Bank Financial - Analyst*

And I ask because it strikes me that there might be more to the game than just getting the mortgage, that getting someone happy with a reasonably priced mortgage product, who has the wherewithal to endure or take on a 25-year amortization, a short amortization period, might be the type of client you're after.

Tom Flynn *- Bank of Montreal - EVP & CFO*

Yes, that's absolutely right. It's a product that has the features that we've described. Individuals need to have the capacity to make the payments on the shorter amortization.

And we do think that it's a good product from a customer acquisition perspective. And we're absolutely looking to take advantage of flow and the branches to cross-sell. So, that is all part of what we're looking to do with the product.

Peter Routledge *- National Bank Financial - Analyst*

Okay. All right. I'll take a minute and go out to the audience, see if we have any questions for Tom, either on this product, or we can touch on other issues. Okay. We'll keep going, Tom.

So, let's talk about your North American strategy and talk about it in that context. According to your last supplemental pack, BMO has about 922 branches in Canada, 675 in the US. Understanding this year's got to be a year of integration in the US, there is a stated intention to have as many branches in the United States as in Canada. So, that means there's 250 to go. So, assuming that you expand further in the US, geographically, where might that go to?

Tom Flynn *- Bank of Montreal - EVP & CFO*

The focus geographically that we've had for expansion has been in the Midwest for the last 10 years. And Chicago is obviously the center of that for us. With the acquisition of M&I, we have a number two position in the Chicago market, number one position in the Wisconsin market, and number three position overall in the Midwest states that we compete in.

So, we've got strong positions in those core markets. And we do think that there's virtue in expanding in markets that we're either already in, building share in those markets, or growing in areas that are relatively close to the market and wouldn't have any intention of going to either coast from an acquisition perspective with something that was large because they're competitive markets. Although they're big markets, and for a bank of our size, we think we're better off to stick to the area that we compete in.

And as we look out from our Chicago base, I would say that we look more south and a little west than we do east. And the parts of the US that are east are generally more troubled economically than the environment that we see in the area that we compete in now in the center Midwest or in the South.

Peter Routledge ***- National Bank Financial - Analyst***

So, sort of like a Route 66 strategy.

Tom Flynn ***- Bank of Montreal - EVP & CFO***

I guess so.

Peter Routledge ***- National Bank Financial - Analyst***

Okay.

Tom Flynn ***- Bank of Montreal - EVP & CFO***

But, we are focused on the integration right now, as you said, and we've got work to do over the balance of the year on the integration, and we're very much focused on that.

The other thing I'd say about our acquisition strategy is that we have been disciplined through time. We talked about growing our US business well before we did an acquisition of consequence. And so, while we do want to continue to grow, we equally feel a strong need to make sure that the growth comes at a good price and with good economic returns.

Peter Routledge ***- National Bank Financial - Analyst***

Since we're in the US, let's talk about your footprint there. I think BMO has a Midwestern strategy, but, the US Midwest is very varied economically. Can you talk about BMO's specific economic prospects, not of the Midwest but of BMO's footprint in the Midwest?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

We think it's a very good story. The first point would be that it's a big market, the GDP of the states that we operate in is bigger than the GDP of Canada. So, it's a big market.

The unemployment rate is lower than the unemployment rate of the US overall by about 50 basis points. The GDP growth rate is about in line with the overall average in the US, and the personal income level in Illinois and Wisconsin, our two largest markets, is well above the Midwest average.

So, demographically and economically, we think it's a good region. The lower-growth parts of the Midwest are really further east again. And we've looked at things over time further east in both Michigan and Ohio and have concluded that those things didn't make sense because the environment is tougher. And part of the reason that we would look to look more south and a little west is because we think that's going to continue for some time.

So, the region is doing well and has a nice diversified economy as well. So, there's a good manufacturing base, good agricultural base, which is doing very well, and in Chicago, a very vibrant metro market, which is the third largest in the US.

Peter Routledge ***- National Bank Financial - Analyst***

Looking at your US regulatory filings, I noticed just quarter over quarter, so third quarter to fourth quarter 2011, overall loans were flat, yet in your last quarter ending in January, you talked about having $1 billion in organic new commercial and industrial loan growth in the US. So, can you talk about the dynamics about what's happening in your loan book right now? And then assuming you keep the same momentum or maybe improve it through the balance of the year, how will that balance sheet develop later this year?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

We did have positive growth in our commercial book in the BMO first quarter. Our US regulatory filings are on a different month end. And so, the numbers don't totally jive. Basically what we see is a retail book that is flat, maybe down a little bit, which is consistent with the overall environment, given US consumer deleveraging, and we think that's going to continue through the balance of the year.

We have a relatively small runoff commercial real estate portfolio from the M&I acquisition that will continue to runoff over the next year to two years. That portfolio was about $3 billion in size, so not that large, but it will have some negative drag on the overall growth rate that you see.

And away from that, the core C&I portfolio is starting to show nice growth. So, we had over $1 billion since Q3 of last year, which is an annualized growth rate of about 14%. And we're seeing encouraging signs there, good pipeline. And we would expect to see continued growth on the commercial side and net loan growth overall off that base over the balance of the year.

Peter Routledge ***- National Bank Financial - Analyst***

So, you keep that 14% organic growth rate, assuming it continues, and that’s a big assumption, but you'll have your commercial real estate portfolio run off. And now, all of a sudden, you will have material and noticeable...

Tom Flynn ***- Bank of Montreal - EVP & CFO***

…That would be the hope. And time will tell whether we keep the 14%. But, we're absolutely expecting growth in the core C&I portfolio.

Peter Routledge ***- National Bank Financial - Analyst***

Okay. So, one aspect of that level of growth is credit risk. And have you -- has BMO adjusted at all the way it manages or takes on credit risk post M&I, heading into an environment where it might be a very advantageous time to be lending in your footprint?

Tom Flynn *- Bank of Montreal - EVP & CFO*

I would say no. One of our approaches to lending is that we like to be consistent through the cycle. And so, we haven't significantly changed our risk appetite in the US or in Canada. In the M&I business, they were overweight commercial real estate and overweight developer in particular. And so, that part of their portfolio has changed and will change. But, our approach to lending has continued to be pretty consistent and will be going forward.

Peter Routledge *- National Bank Financial - Analyst*

Your colleagues from M&I, how much of a transition do they have to make to BMO's credit culture? I mean, was it big, or?

Tom Flynn *- Bank of Montreal - EVP & CFO*

I'd say not that big with one exception. And their core C&I portfolio looked a lot like ours. And their approach to the business was very consistent. And so, there, there's not a big change in the way business gets done or the kind of business that we're doing. And so, it's pretty much business as usual.

On the developer side of the business, they were running that portfolio off. And there was a significant change through time. And the aggressive lending that they were doing in that portfolio won't come back. And that decision was made years ago. And we've, I would say, reinforced it.

And on the retail side of the business, there really wasn't that significant a difference.

So, they had a portfolio that absolutely had issues. But, I think everyone recognized that that didn't work out well. And it made sense to change.

Peter Routledge *- National Bank Financial - Analyst*

Okay. And probably a good time to go back out and see if we have any questions for Tom. You'll have one or two more chances. So, keep thinking of questions.

We'll go over to the bank's Private Client Group strategy, which you've seen pretty good earnings momentum in that segment over the last couple years. And that is in part just good organic growth combined with usually accommodative markets. And you've expanded PCG's product line to include more life insurance. That was following the AIG life insurance product sale or product acquisition.

But, one thing that line of business creates is earnings volatility in this interest rate environment. So, how are you managing -- or as CFO, how are you looking at that business, the life insurance business and the volatility it brings into PCG?

Tom Flynn *- Bank of Montreal - EVP & CFO*

Well, I'd say we have done things to reduce the volatility and continue to focus on that. And those things include increasing the amount of credit assets in the portfolio away from governments, which gives us a pickup in spread, which helps mute the volatility. Extending the term of our asset duration to reduce the mismatch between asset term and liability term.

And what we haven't done is we haven't stopped the business from growing. And our view has been that, although we do have exposure to rate movements, the exposure isn't outsized in the context of the overall earnings of the bank. And the sensitivity is about $9 or $10 million of revenue for every 10 basis points move in rate. So, it's not trivial, but it's not huge either in the context of the bank.

And at this point, we've kind of ridden the exposure down as rates have declined. And the hope is that rates are bottoming here. And we'll have some benefit as we move up.

We have tried to be pretty clear from a disclosure perspective about the impact of the exposure to rates in the business. So, we've talked about the core wealth performance away from insurance, which has been very strong. We've had very strong double-digit growth in income for the last I think six quarters.

And we're really happy with how the acquisition of the AIG business has gone. We bought that business at just a snick over book, sort of at a bad time for AIG. And life insurance businesses, as you know, are typically sold at two times book give or take. So, we paid a great price. The business is earning a good return on capital. And there's a nice connection to our wealth businesses. And we think we can manage the distribution well.

And there's a direct component to the business, which has benefited from association with the BMO brand. So, overall, the acquisition's been good. The business fits with our strategy, the returns are just fine, the volatility has been a nuisance for sure at times. But, we think that, given the size, it's not outsized.

Peter Routledge *- National Bank Financial - Analyst*

But, it strikes me the volatility is just a nuisance. And you're competing against large life insurance companies where that volatility is far more than a nuisance. It's a major threat to capital. So, how much of a growth business does this become, assuming rates stay reasonably low over the next couple of years?

Tom Flynn *- Bank of Montreal - EVP & CFO*

I'm not sure that the rate environment itself would result in us having a fundamentally different growth profile than the bigger insurers. And we want to earn a good return on the business that we're writing in the environment that we're dealing in. And that's a competitive market, even at today's low rates across most of the products that we're involved in. So, we do think we'll have above average growth. But, I don't think it'll come from a different risk tolerance, given the exposure to rates.

We think it will come from leveraging our wealth distribution and also the brand association on the direct side of the business with the BMO brand, which consumers take comfort from and like.

Peter Routledge *- National Bank Financial - Analyst*

Okay. Take a minute and just talk about capital and liquidity, which I'm sure you probably think about from time to time in your role. You've already met the Basel III requirements. How will additional counterparty credit risk charges impact BMO's position on Basel III? And then what mitigation strategies exist for next year?

Tom Flynn *- Bank of Montreal - EVP & CFO*

So, we've already met the Basel III requirements, as you noted. We have a Basel III common equity ratio at the end of Q1 of 7.2%, better than the 7% requirement. We do think banks will run well above the 7% ultimately. So, we expect that ratio to grow through the year.

Included in the 7.2% ratio is an RWA number of about $14 billion for counterparty credit risk. So, it's a fully loaded number for counterparty credit risk. And over time, we expect that number will come down pretty noticeably as a result of moving to advanced models and moving derivative activity to clearers.

And that's going to take some time. And by sort of into 2014, ex-growth in the business, there's a good chance that the $14 billion will be cut in half through the combination of those two things. So, there's meaningful upside, assuming that all plays out to the ratio. And every $1 billion of RWA is about 3.5 points on the common equity ratio.

Peter Routledge *- National Bank Financial - Analyst*

So, there's some meaningful capital reduction as this OTC counterpart, central counterparty comes in. Excluding earnings growth...

Tom Flynn *- Bank of Montreal - EVP & CFO*

That's right, which will come through over time.

Peter Routledge *- National Bank Financial - Analyst*

Yes. Okay. Less well understood I think is the Basel III liquidity rules, which have a much longer phase-in period, but which do I think have a material impact on any bank's funding strategy. So, how do you anticipate BMO's funding strategy evolves over time? Are you just going to have to pay higher cost of funding?

Tom Flynn *- Bank of Montreal - EVP & CFO*

Well, I hope not. I guess the first thing I'd say is that our principles behind our liquidity risk management are completely aligned with the Basel liquidity rule principles.

There are differences, though, in sort of the severity of the assumptions that underlie the Basel rules. And I think for the industry generally, they will result in higher levels of liquidity and more term funding being required.

I don't think that those rules will result in significant deposit margin compression because, while deposits will be more valuable under the new Basel rules, they've always been a thing of beauty. And deposits are wildly profitable or nicely profitable....

Peter Routledge *- National Bank Financial - Analyst*

… Except in today's environment.

Tom Flynn *- Bank of Montreal - EVP & CFO*

Except in today's environment. But, even in today's environment, on a risk-adjusted basis, the return on capital, given that there isn't any capital, is very attractive. And clearly, they're a relationship product, and so you've got to look at things on a total relationship basis.

But, I think the point I'm trying to make is that deposits have always been a very attractive product. They'll continue to be a very attractive product under the new Basel liquidity rules when they get phased in. And the result that they will be somewhat more attractive I think doesn't fundamentally change their character and, to me, shouldn't change the margins that go with them.

What will change is banks will have more term funding. And so, at the margin, subject to how that gets passed onto customers, there's the potential for some margin compression.

The liquidity rules have not yet been established definitively, as you know. So, the Basel Committee has said that the framework is set. But, there will be changes to some of the parameters that are used in the calibration. And that will play out we think over the balance of the year for implementation in 2015. So, it's all a bit away.

Peter Routledge ***- National Bank Financial - Analyst***

Okay. As banks term their funding out more, pretty much every Canadian bank runs a gap where they have more domestic loans than domestic deposits, which implies that, excluding everything else, the cost of funding that gap will go up under Basel III. How do you currently allocate the cost of funding that gap into the P&C bank? And will you change that allocation method at all in light of the Basel III liquidity rules?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

We currently fully charge the business for the cost of the term funding that's required to support the business. So, in our retail businesses…well, really Canada only right now because, in the US, we're in a net deposit position, there are net assets that we fund away from customer deposits. We fund all of those loans with term money, none with short-term money, and the cost of that term funding is passed on.

So, the Basel rules won't impact the profitability of the business in any way sort of in that small circle. There will be some additional supplemental liquidity requirements that go along with loan commitments and deposit runoff risk factors that will result in some incremental charge. But, the basic framework, again, is consistent with the new Basel rules and fully charges to the business the cost of the term funding that's required.

Peter Routledge ***- National Bank Financial - Analyst***

The P&C banking segment in some respects already feeling the pinch from terming out your funding, will look at the deposit as more attractive and start competing more aggressively for it.

Tom Flynn ***- Bank of Montreal - EVP & CFO***

It takes us back to the earlier conversation. And I'm not sure that will be the case because, again, the product is already a very attractive product, and I don't think that many banks are leaving much on the table in terms of the way they're competing for deposits.

So, the deposits will be more attractive under the new Basel rules. But, they're already so attractive that I'm not sure that incremental amount results in a meaningful change in the pricing environment or the competitive environment.

Peter Routledge ***- National Bank Financial - Analyst***

Right. Okay. Well, we have a few minutes left. We have a question here.

Unidentified Audience Member

Since you guys were talking about cost of funding, as subordinated debt in your capital structure loses its capital treatment as the years go on and Basel III -- I mean, we've been to an NVCC sort of issuance for capital and given that the cost of NVCC's probably going to be higher than that of sub-debt, what's your sort of bias towards sticking with deposit notes to fill in that gap versus using NVCC to gain capital treatment as well as being able to fund your loans in that gap?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Yes, I'd say a couple of things. I think since the financial crisis, the market generally and banks and regulators and rating agencies have paid more attention from a capital perspective to the core common equity capital ratio than either a tier one ratio or a total capital ratio.

And so, over time, my expectation is that non-common capital, including sub-debt, will form a smaller portion of the capital structure than it pre-downturn. And given how our capital structure is currently configured, we've got enough non-common capital to last us under the grandfathering rules under Basel for some time.

And our focus from a funding perspective will be more on senior notes than NVCC kinds of capital. And I don't think we'll be one of the first banks to go down that route. And through time, I think the issuance will be small as it relates to the non-common part of the capital structure relative to what it has been historically.

Peter Routledge ***- National Bank Financial - Analyst***

You have another question for Tom? Okay. I'm going to, Tom, jump over to capital markets and just ask about BMO Capital Markets' North American wholesale strategy. I think people are pretty familiar with your Canadian business, which is quite strong and quite profitable. But, you -- BMO has made a push into the United States and has a midcap strategy. Can you talk about the state of that strategy right now?

And I think last quarter -- last four quarters' net income from BMO Capital Markets in the US was $84 million. And what do you see as a good goal for this business in 2013?

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Sure. So, we have been investing in the business basically through upgrading talent, and building out distribution. And we were able to do that through the downturn when there were basically opportunities to attract talent. And we've been happy with the way that we've built out distribution on the equity side and on the debt side. And we've increased the alignment between our research, our investment banking, and our distribution to create better verticals in sectors that we want to compete in.

So, we feel good about the fundamental competitiveness of the business. We think it's important to have a good US business to be relevant to some of our clients in Canada who want to have a North American perspective on things. So, there's some synergy with the Canadian business that flows from the US business. And we're looking forward to the investments that we've made fully paying off.

And the level of income that we're getting from the capital market business in the US reflects the cost base of the investments but not the full revenue potential, takes a few years for teams to gel and the brand to build and the revenue to follow. And we think we've got the base in place to allow for that.

We've had some good successes on the equity financing side, the municipal financing side, and the research side. We're in the Wall Street Journal ranking of research analysts, we ranked in the top five banks with the number of top stock pickers.

So, we think we've got the conditions in place to do well as the market improves and, into sort of next year, would expect a meaningfully higher level of profitability than we've currently got from that business, basically as we get our revenue lift from the current expense base.

And as you would know from looking at our supp pack, the productivity ratio of that business in the US is pretty high, far higher than the overall business or the Canadian business. And we think that there's a lift to come there as we get the benefits from that investment over the next few years.

Peter Routledge ***- National Bank Financial - Analyst***

All right. Well, Tom, we're just at the end of our time. So, I'll thank you very much for coming and wish you all the best for the year.

Tom Flynn ***- Bank of Montreal - EVP & CFO***

Thank you.