Bank of Montreal at the Barclays Global Financial Services Conference

CORPORATE PARTICIPANTS

Tayfun Tuzun
CFO

CONFERENCE CALL PARTICIPANTS

John Aiken
Equity Analyst, Barclays

Non-GAAP Measures and Other Financial Measures
Results and measures in both Management's Discussion and Analysis (MD&A) and this document are presented on an IFRS basis. We use the terms IFRS and Generally Accepted Accounting Principles (GAAP) interchangeably. We use a number of financial measures to assess our performance, as well as the performance of our operating businesses, including measures and ratios that are presented on a non-GAAP basis.

Management considers both reported and adjusted results and measures useful in assessing underlying ongoing business performance. Adjusted results and measures remove certain specified items from revenue, non-interest expense and income taxes. Adjusted results and measures presented in this document are non-GAAP. Presenting results on both a reported basis and an adjusted basis permits readers to assess the impact of certain items on results for the periods presented, and to better assess results excluding those items that may not be reflective of ongoing business performance. We believe that these non-GAAP amounts, measures and ratios, read together with our GAAP results, provide readers with a better understanding of how management assesses results.Non-GAAP amounts, measures and ratios do not have standardized meanings under GAAP. They are unlikely to be comparable to similar measures presented by other companies and should not be viewed in isolation from, or as a substitute for, GAAP results.

Examples of non-GAAP amounts, measures or ratios include: efficiency and leverage ratios calculated using revenue presented net of CCPB; revenue and other measures presented on a taxable equivalent basis (teb); pre-provision pre-tax income; amounts presented net of applicable taxes; adjusted net income, revenues, non-interest expenses, earnings per share, effective tax rate, ROE, efficiency ratio, and other adjusted measures which exclude the impact of certain items such as acquisition and integration costs, amortization of acquisition-related intangible assets, impact of divestitures, restructuring costs and management of fair value changes on the purchase of Bank of the West. Bank of Montreal provides supplemental information on combined business segments to facilitate comparisons to peers.

Certain information contained in BMO's Third Quarter 2022 Management's Discussion and Analysis dated August 30, 2022, for the period ended July 31, 2022 ("Third Quarter 2022 MD&A") is incorporated by reference into this document, including the Summary Quarterly Earnings Trend section in the Third Quarter 2022 MD&A. Quantitative reconciliations of non-GAAP and other financial measures to the most directly comparable financial measures in BMO's financial statements for the period ended July 31, 2022, an explanation of how non-GAAP and other financial measures provide useful information to investors and any additional purposes for which management uses such measures, can be found in the Non-GAAP and Other Financial Measures section of the Third Quarter 2022 MD&A. Further information regarding the composition of our non-GAAP and other financial measures is provided in the Glossary of Financial Terms section of the Third Quarter 2022 MD&A. The Third Quarter 2022 MD&A is available on SEDAR at www.sedar.com and BMO's Third Quarter 2022 Report to shareholders is available at bmo.com/investorrelations.

PRESENTATION

John Aiken - *Equity Analyst, Barclays*

Good morning, ladies and gentlemen. Next up, Tayfun Tuzun, Chief Financial Officer of Bank of Montreal. Tayfun, thank you very much for joining us. And as we just said, it's an absolute pleasure to see you in person.

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. Thank you. Thank you for inviting us, and it's great to be back after a 2-year hiatus.

QUESTIONS AND ANSWERS

John Aiken - *Equity Analyst, Barclays*

Tayfun, before we get into the line of questioning, since this is the first time we've had you physically here since you joined Bank of Montreal, I was hoping to talk about what attracted you to the BMO platform because it is a little bit different than obviously what your previous employer was doing.

Tayfun Tuzun - *Bank of Montreal - CFO*

It is. Just as a reminder, I was at Fifth Third Bank in Cincinnati for 13 years and the last 7 as the CFO, great company. I had a wonderful time and many opportunities for professional growth. But BMO truly presented me with a significantly different step forward as the size of the company as well as the geographic scope and the business scope was very different. And having gone through many discussions with the management team, predominantly with Darryl, I also became very engaged in their strategic thinking because the summer before I joined the bank, there was a significant overhaul of the strategic plans, the long-term strategic plans. And I truly bought into their plans and it was a professional growth opportunity. And the last 2 years basically proved that it was a good move, and I have learned a lot, not only about the company, but about the Canadian economy and the Canadian industry structure, which tends to impact performance. It's a very different setup than the U.S. So I enjoyed my tenure so far at BMO. And I look forward to continuing the type of performance that we have displayed over the last 2 years in the future as well.

John Aiken - *Equity Analyst, Barclays*

Tayfun, going back to last quarter's results. Net interest income growth was quite impressive, at least from my standpoint. Can you talk about the drivers of this growth, both volume and margin expansion and provide an update in terms of what your outlook is going forward?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. These days, when we speak about net interest income, the first thing that comes to our mind mostly relates to environmental factors to interest rates. But as much as interest rates play a role in how strong our net interest income grew over the past year. The more important point from my perspective is the results of the investments that we have made in the business over the past 4 or 5 quarters and how much they have impacted growth across the board. And net interest income is clearly one of those variables that moved very positively.

Look, our margin story is very strong. We have been able to protect the downside very effectively post Covid. And it was a deliberate management strategy to stabilize the margin across the full interest rate cycle, and it worked very well. Our margin was very, very stable going back to Q4 2019 and onward. And that was a result of a very engaged hedging strategy. But now with interest rates moving up, the upside is coming more from the business side, the ability to maintain and grow spreads on the loan side, as well as very strong deposit spread reaction as a result of short-term rate increases. That involves, especially on the commercial side, our predominantly lead relationships and the ability to engage with the clients and not let pricing drive those relationships. So that gives you an ability to protect margins, spreads when they come under pressure. So that's working in our favor.

Our asset sensitivity remains very much in the middle of the pack in Canada. When you combine the ability to protect the downside and also to leave room for improvement, our margin grew 16 basis points, excluding trading year-over-year and 10 basis points quarter-over-quarter. So that's an important element. But more importantly, the other variable, obviously, that determines net interest income is loan growth and we have seen loan growth on both sides of the border, 12% year-over-year in Canada, 13% in the U.S. and even on a quarter basis, 4% in Canada, 2% in the U.S. These are very strong growth numbers. And they do reflect some of the macro environmental factors, but more so, they reflect the expanded sales force and growing client base. When you look at the subcomponents in our residential lending, which combines mortgages and HELOCs, grew 12% year-over-year, strong growth. We had 15% growth in business banking; credit cards, again, once again, are growing 19% year-over-year, 9% quarter-over-quarter. I'm giving these year-over-year and quarter-over-quarter numbers because they do reflect acceleration in some of these components, because credit cards, especially given more swipes from the consumers and a slowly increasing revolver balance is helping growth. Commercial was very strong year-over-year, 16% in Canada, 15% in the U.S. Relationships are expanding. Utilization rates are slowly moving up as well.

So when you combine such a strong NIM performance with such strong loan growth, net interest income grew 22%, excluding trading year-over-year, 12%, 13% quarter-over-quarter. I have never seen in my 30 years of professional engagement in the banking industry a 22% growth in NII. So I will come back to the original statement that I made. It's not just because short term rates are rising and longer-term rates on an absolute basis are at a higher level. It's really a combination of some deliberate actions on our side combined with the macro factors. So that's the NII story.

Our outlook on loan growth is still constructive. We can get into the macro issues because they are going to be impactful on the future path of loan growth, especially in 2023 and into 2024. But for now, we believe that both in Canada and the U.S., there is enough fundamental economic support for loan growth. And as such, net interest income should have a very healthy path forward. I always have viewed NIM more as a derivative of net interest income and loan growth. So as such, we will continue to discuss NIM, obviously, the outlook for the short-term forward rates as well as the yield curve shape.

John Aiken - *Equity Analyst, Barclays*

And Tayfun, one of the interesting things with NIM and as you say, it's almost an overarching and almost too blunt metric, at least from my standpoint, because you don't really get all the details. Changing mix will positively or negatively affect everything else and things like that, but one of the really fascinating things that I've noticed this go around is in terms of deposits. And the fact is that even though we're now at a point where loan growth is a little bit outstripping deposit growth, it still remains very strong. What dynamics are you and the bank seeing that's driving this? And how are we going to be at some point down the road where suddenly deposit growth flattens out or lags loan growth to a certain degree?

Tayfun Tuzun - *Bank of Montreal - CFO*

And on that topic, there are differences between Canada and the U.S. There are differences in the way deposits are priced in this rising rate environment. There are also differences in the way growth is materializing. In Canada, for example, our year-over-year deposit growth was 9% and our quarter-over-quarter deposit growth was, I think, close to 4%, whereas in the U.S., we had a stable year-over-year performance and about a 2% decline in deposits quarter-over-quarter. And the outcome in Q3 was very much in line with how we modeled and how we forecasted the right side of the balance sheet.

The U.S., there is an element here, and this touches upon our NIM progress as well., we had very significant growth in deposits since pre-COVID, which tends to impact NIM positively, but also built significant liquidity in the U.S. And we continue to be less active in the U.S. in meeting some of the price competition. So we have enough liquidity despite strong loan growth so far, we have been able to use the existing funding stores. So we are a little bit behind maybe which is resulting in more stable outcomes in the U.S. But in the U.S., the advantage that we have on the other hand is deposit betas are a lot more dynamic in the U.S. So as rates are rising, spreads are widening more so when you think about our margin in the U.S., it was up, I think, 20 basis points quarter-over-quarter. That's a reflection of deposits.

Going forward, and I'll stick with the U.S. for a moment; as you know, we built a national digital deposit gathering platform in the U.S. We have not turned that on yet. But as loan growth continues to remain strong, at one point, we will probably turn that on. So I suspect deposit growth and volumes will reflect that when we make that deliberate decision. In Canada, we had good liquidity in Canada. But as we move forward, we have already started growing deposits in Canada to support the strong loan growth, 12% year-over-year loan growth and continuing quarterly loan growth, we'll need some deposit funding.

And naturally, as rates have risen, customers have a preference for term deposits now. And we are seeing some migration from non-maturity deposits into term and also additional growth in term. But it's not in large quantities or in large numbers. We only saw a 2% change in the percentage of term deposits as a percentage of the full pool, it's moving slowly. It's more visible today, but I think there will be a continued shift into term deposits in Canada. Although the profitability of the transactional deposits is higher, we still are benefiting from positive spreads even on term. And I think that deposit growth in Canada will be in more lockstep with loan growth.

So a little bit of a delay in the U.S., continued growth in Canada. And I will add to that also, we have been very successful in growing market share in deposits. So in addition to macro factors, our ability to expand our presence in the deposit market is also helping us to keep a very healthy picture for liquidity in Canada.

John Aiken - *Equity Analyst, Barclays*

Fantastic. Can you provide an update in terms of Bank of the West, where the process stands but then also talk about just what was the impetus for the acquisition? What does it bring to your platform?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. We continue to be very excited about the prospects. We are going through the regulatory process. And when we announced the transaction in December, we said our expectation is that we will be able to close this transaction in the first quarter of the new fiscal year, and that is still our assumption. You never get a confirmation on the regulatory side, you just have to watch the process. And I think both in the U.S. as well as in Canada, the regulatory teams are very closely engaged, and it appears to us that the process is moving forward.

What we liked about Bank of the West, stepping back for a moment, we believe in scale. And therefore, it's been a long-term public stance here at BMO that growth in the U.S. to increase our scale was an important factor. And we're always interested in making sure that the strategic purpose of a prospective transaction is matched equally with the financial picture of that prospective transaction. And we were very happy to engage BNP in a conversation, and we were very happy that we ended up actually signing the agreement. It not only gives us sort of an immediate scale with the existing force that we bring to the table and that they bring to the table. There's a geographic element to this. California is the eighth largest economy in the world. It's a larger economy than the Canadian economy, it's right behind Germany. Having a very concentrated presence in California gives us an immediate step into California. We have been actually very interested at BMO even before the transaction in putting more sales force on the ground in California. So this is an immediate entry.

It is a company that is a very well-run company from a risk profile perspective. It matches our risk profile. And it has a very attractive deposit base. Like these days, we talk about deposits quite a bit. Their deposit base is even stronger than ours. It's a purely transactional base, and client relationships are very strong. They have a very good middle market banking franchise. And on top of it, we believe that we bring certain capabilities to them to lift their performance. No offense to how BNP ran the business, but we have some advantages in the way we utilize technology. We have a high-performing retail branch network, and we have a growth-oriented commercial bank in the U.S. And when you put the two organizations together, it is inevitable that from a revenue perspective, performance will lift, and we have made some predictions in terms of our ability to create some revenue synergies, $450 million to $550 million in revenues. On top of the cost synergies that we announced, 35% cost savings is very impactful on the bottom line. And we're pretty confident that we will be able to achieve that.

And this all happened when we significantly improved the existing BMO franchise's performance in the U.S. So 5 years ago, the U.S. franchise was dilutive to the BMO franchise from an efficiency perspective and from a return perspective. Now it's at par. So now we basically are adding more scale to the U.S. And so the contribution to the consolidated BMO franchise is going to be significant. Our sales teams are very excited and so our counterparts at Bank of the West. We have been able to get together in over the past seven to eight months to chart the integration and conversion. So both sides are extremely excited. We're just waiting for the closing.

John Aiken - *Equity Analyst, Barclays*

Fantastic. I'll pause here just to see if we have any questions from the audience.

Unidentified Participant

Thank you for the update. I just have a technical question. I mean how do you see duration performing in Canada? Because obviously, the way the mortgage market works and there's been a prepayment, when interest rates were lower, but depending on certain rates, the duration of the book… I mean you obviously said you're winning deposits in order to match that duration. But I don't know if you have any comments around sort of the levels of which you get that convexity issue?

Tayfun Tuzun - *Bank of Montreal - CFO*

So I think your question touches upon mortgages, do I understand it right? It's a broader question than just mortgages. In terms of mortgages, look, we have the smallest percentage of mortgage loans on our balance sheet relative to other Canadian banks. We have a proprietary mortgage focused business strategy. So it's a relationship-based approach. And from a growth perspective, we saw 7% growth in mortgages year-over-year, 3% quarter-over-quarter. Growth continues even in this environment and mostly due to the fact that, again, we've expanded the sales force over the past 5, 6 quarters, which is helping us grow mortgages. And we're growing it at a very sort of -- from a risk perspective, comfortable level. It's a combination of how we underwrite mortgage loans, what type of stress tests that we do at the time of underwriting and what the balance sheet looks like today. Canada is exposed to housing market challenges, but at the same time, the profile of the existing mortgage book lends itself to a significant amount of room before it really touches portfolio performance. And I can get into that later.

In terms of growth, our expectation is that clearly, GDP growth is going to slow down into 2023. We're not yet expecting, our economics department is expecting growth down to low single digits, but not yet in negative territory. It could happen. We will continue to evaluate the macro events. It appears that from a rate outlook perspective, there is a gap that's appearing between Canada and the U.S. in the sense that I think the peak short-term interest rates in the U.S. are going to exceed the peak short-term interest rates in Canada. That should, on a relative basis, bode better for Canada and the Canadian economy. Unemployment continues to be very low, just like in the U.S. and Canada also is an economy has a little bit of an advantage with a more commodity heavy nature. And what we have seen so far on the ground today because Canada came out of the COVID restrictions a bit later, the growth profile right now is ahead of the U.S. We think that eventually will catch up.

But although we are expecting slower loan growth into next year relative to the double-digit loan growth that we are seeing today. In my view, for the next year, year-and-a-half, as it always has, loan growth tracks more to nominal GDP growth rather than real GDP growth. And if we believe that although inflation will come down, that decline will be slower. We should still see an above historical average loan growth next year, but below the current levels. We can get into the credit discussion beyond just growth prospects. That sort of is probably more of a commercial answer. On the consumer side, I think it's inevitable that mortgage growth will slow down. But I don't think that it's going to fall off significantly. And I also believe that our current strength in capturing some of the refi volumes should keep a pretty decent support in terms of the portfolio outstandings. And then we're also seeing some growth in HELOCs now. I mean, I think the environment is a better environment on the resi side to shift some of that growth from mortgages to HELOC. And then credit cards, in general, we're still below revolving balance percentages compared to pre-COVID. So there's probably still some room there as well.

Unidentified Participant

Can you give us your view on private as well as the subprime mortgage lending that's going on in Canada? I understand that the specific banks have LTV ratios in 50% range across the board. But can you just give us your view on how you look at the subprime and the private lending to mortgages in Canada? And could we have your view on impacts to the economy from a ripple perspective just because of the 5-year resets?

Tayfun Tuzun - *Bank of Montreal - CFO*

So I mean, I'm going to answer the question from our perspective. Our average FICO score is 793 in our residential lending portfolio. And our current LTVs are, I think, below 50%. And as such, the downturn, we do have a significant amount of cushion that can absorb all of this expected downturn. In terms of private lending, I don't believe that the banking sector necessarily is going to feel an impact of the downturn. Canadian mortgages have a significantly different profile than U.S. mortgages. I've learned this over the last 2 years, watching the industry and watching performance. So I'm not going to give you an answer that's going to sort of be insightful in terms of private lending, non-bank lending in Canada, but we are quite positive even if we see -- and it's likely that we will see a double-digit downturn in housing prices. But even with that, that only takes you to a year ago where the housing prices were because there was such an increase. And fundamentally, immigration provides a significant support to housing and housing prices. In 2024, the Canadian government is targeting somewhere north of 400,000 people coming into the country. So the dynamics are quite different. Some of the concerns that we've always maintained in the U.S. with respect to non-bank mortgage lending, the subprime sections don't apply in Canada and especially in the banking sector and especially at Bank of Montreal. We don't have a subprime business. We are a very high prime focused company.

John Aiken - *Equity Analyst, Barclays*

One of the topics for the Canadian banks around housing was the variable rate mortgages and how the interest rate hikes are impacting that. Can you talk about BMO's profile in terms of the variable mortgages and what do you expect over the next couple of years as those are having to be repriced?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. I think at the moment, if you look at our portfolio composition, I think, 73%, 74% of our mortgages are fixed rate. And as you know, in Canada, variable rate mortgages are not quite the same as in the U.S. When rates go up, payments don't adjust, we change the amortization schedule and up until the maturity date, payment stays the same. Only 10% of our mortgages are coming up for renewal in the next 12 months. And so therefore, when you combine that with the rate stress that we use at the time of underwriting, testing the borrower's ability to pay higher rates, higher of 5.25% or customer rate plus 200, we are quite positive on the credit profile and we've looked at different layers of the portfolio. So as I said, only 10% of mortgages come up for renewal in the next 12 months, when you look at the FICO distribution and the LTV distribution, there's only $17 million left that is specific to borrowers who have below, I think, a 690 FICO score and an LTV above 70%. So the core risky part of the portfolio that would be subject to a potential rate shock is an extremely small portion of our mortgage book, our mortgage book is $136 billion. So we're talking about really miniscule numbers. And our historical performance in mortgages has been very, very strong. So when you put it all together, yes, there is going to be an element of stress on certain parts of the population, but we're quite comfortable with where we are and our ability to manage through this.

John Aiken - *Equity Analyst, Barclays*

Well, Tayfun in terms of obviously, the top line growth has been exemplary. And while we're expecting some headwinds, obviously, expectations are to grow. The other side of the argument, though, is expenses, inflation, and honestly, the stories that we're hearing about attracting and retaining talent. Can you talk about what your expectations are for expense growth moving forward and expectations for either operating leverage or efficiency depending on how you look at it?

Tayfun Tuzun - *Bank of Montreal - CFO*

So I'll start with operating leverage. We have a long-standing commitment to positive operating leverage. And we have, I think, for the past, I can't remember now, eleven quarters or so. The only quarter where we had negative operating leverage was this quarter and not on a run rate basis. I'm not making excuses, but there were two factors this quarter. One was a markdown in our leverage loan commitments and the other one was a severance charge. Outside those two, we would have had positive operating leverage. So that's just to reiterate our target level performance. And the reason for that is we still have a slight gap. Although our efficiency ratio has improved over 500 basis points in the last 5 years, there is still year-to-date, our efficiency ratio relative to our peers, there's still a 1% gap. So in the initial stage, our target is to move below the peer average.

So having said that, this year, we've had, just like all the banks and all the other commercial companies, we felt the pressure of especially compensation inflation. And we are very focused on both retaining the talent, and over the past, as I mentioned, 7, 8 quarters, we have been very focused in growing talent in our company. That goes to the sales force as well as significantly to the technology IT side. But having said all of that, we still have managed our expenses, what I would describe within a very reasonable range. Our expense growth, including the impact of divestitures and excluding the impact of performance-based comp is still at 2.5%, 2.4% was, I think, the number in Q3. And we expect to maintain that. And that's been a combination of both a very tight control of expenses in the company on a discrete basis. But at the same time, we are seeing the positive impact of some of the investments that we have made that continue to improve the efficiency in our operations.

One good aspect of that is in our retail business. As you know, the retail business consumes a lot of the compensation cost in the company. We have made significant improvement in sales to service ratio in our brand system, which helps obviously the revenue side, but which also helps the expense side. As we look forward now, given the fact that the revenue environment is going to be a bit different, assuming that there's a slowdown in the economy, we are being more cautious. The investments that we have made over the past 7, 8 quarters were the right investments at the right time. We are seeing the results. But now we need to be a bit more cautious in our expansion plan. So we'll slow that down, which will help expense control. We are also working very hard on both creating more efficiency in the way we generate technological improvements but also changing the timing of some of the technology projects as appropriate. Digital first is still our motto. But the ability to manage these two pressure points will enable us to continue to operate towards that positive operating leverage and optimistically still make more progress towards getting below the peer average in terms of the efficiency ratio.

John Aiken - *Equity Analyst, Barclays*

Tayfun, BMO has got a decided focus on commercial lending on both sides of the border. And we've seen the benefits of that from the growth that you pointed out. But I guess, in terms of an environment where expectations are for normalization on credit, what are the concerns moving forward if we do hit a modest recession? What are the expectations for the evolution of credit losses? And in terms of your stress testing, what are you seeing in your risk case scenarios that actually provide comfort for your level of allowances?

Tayfun Tuzun - *Bank of Montreal - CFO*

Yes. We are coming out of a very, very benign credit environment, and we are cognizant that is not going to last. And our expectation is that our impaired PCL will start moving up towards sort of the high teens, low 20s level. The one thing that I always tell people, when we talk about credit is -- we live in a cyclical business. We have learned to live in a cyclical business. Our business is about risk management. We don't underwrite loans and assume that these loans will be on our balance sheet only during the benign times. So therefore, at the time of underwriting and post underwriting, as you mentioned, stress tests are important to gauge, and we don't see a significant exposure even under stressed environments. Our portfolio has evolved significantly compared to, for example, 5 years ago, we have a more diverse commercial portfolio. The percentage of investment-grade loans has gone up 10% in that time period. And of the loans that are below investment grade, 90% plus of them are collateralized. What gives us comfort is the fact that we are the lead bank in 90%+ of our relationships. We know the customer well. In most cases, these are long-term relationships. And that gives us both the comfort that we are reading their business appropriately in assessing the risk as well as our ability to work with them when there are inadvertently tougher times.

What changes most in these types of cycles is where growth is coming from, so away from credit in terms of the shape of growth going forward. In the past couple of years, commercial real estate, sponsor funding, they were strengths in providing some support for growth. I suspect that as we move forward into the next phase of the business cycle, you will see more growth in asset-based lending. You will see more growth in credit lines to support working capital. I think we expect auto floor lending, for example, to sort of slowly pick up from it is. So the nature of the portfolio growth will change. But we've had 7 quarters in a row of positive credit migration in the commercial book, 11 quarters in the consumer book. Those trends don't reverse very quickly. And so when you consider from where we started 7 quarters ago in commercial 11 quarters ago in consumer, the profile has changed significantly. Even if there are some weaknesses in the portfolio, we still have a lot of room before we start seeing best levels of credit performance. And our historical performance in general would indicate that we are very good underwriters, and we are very good risk managers and as such, we feel pretty strongly.

John Aiken- *Equity Analyst, Barclays*

Unfortunately, we are at time, so we are going to have to call it there.

Tayfun Tuzun - *Bank of Montreal – CFO*

Thank you for having us.