BMO Financial Group
Q3 2010 CONFERENCE CALL

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PRESENTATION

Operator

Good afternoon and welcome to the BMO Financial Group's third quarter 2010 conference call for August 24, 2010. Your host for today is Viki Lazaris, Senior Vice President of Investor Relations. Ms. Lazaris, please go ahead.

Viki Lazaris - *BMO Financial Group - SVP, IR*

Thank you. Good afternoon everyone and thanks for joining us today. Our agenda for today's investor presentation is as follows. We will begin the call with remarks from Bill Downe, BMO's CEO, followed by presentations from Russ Robertson, the Bank's Chief Financial Officer and Tom Flynn, our Chief Risk Officer. After their presentations, we will have a short question-and-answer period where we will take questions from pre-qualified analysts. To give everyone an opportunity to participate, please keep it to one or two questions and then re-queue. We will wrap up the call at 3 p.m.

Also with us this afternoon to take the questions are BMO's four business unit heads -- Tom Milroy from BMO Capital Markets; Gille Ouellette from the Private Client Group; Frank Techar, head of P&C Canada; and Ellen Costello from P&C US.

At this time, I would like to caution our listeners by stating the following on behalf of those speaking today. Forward-looking statements may be made during this call and there are risks that actual results could differ materially from forecasts, projections or conclusions in the forward-looking statements. Certain material factors and assumptions were applied in drawing the conclusions or making the forecasts or projections in these forward-looking statements. You can find additional information about such material factors and assumptions and the material factors that could cause actual results to differ in the caution regarding forward-looking statements set forth in our news release or on the Investor Relations website. With that said, I will hand things over to Bill.

Bill Downe - *BMO Financial Group - President & CEO*

Thank you Viki and good afternoon everyone. As noted, my comments may include forward-looking statements. BMO's third quarter results were solid, underlying the benefit of the bank's diversified business mix.

Three factors were particularly significant in these results. P&C Canada maintained its strong performance, including market share gains, with results up 17% from last year and 8% from a robust Q2. Second, our capital markets results reflect lower trading revenues, particularly relevant to recent quarters where we had good spreads and capitalized on some unique market opportunities. And finally, we experienced a continued significant reduction in loan loss provisions, better than we had anticipated.

Net income was $669 million, 20% above last year. Cash EPS came in at $1.14 a share. Our ROE for the quarter was 13.7% and we posted 14.8% year to date. At $214 million, our third quarter provisions for credit losses reflect the continuation of a positive trend. PCLs were $203 million better than last year and $35 million better than last quarter. Gross impaired loans and formations declined sequentially. There is a credit recovery underway and we have confidence in the overall continued positive trend and Tom Flynn will provide more color later in the call.

Russ is going to take you through our group results in more detail, but let me touch on the quarterly highlights. P&C Canada continues to set the pace for the Company. We are deepening customer relationships across all of our businesses, highlighted by year-over-year increases in the average number of product categories used by both personal and commercial customers, strength in commercial banking with increases in market share and growth in loans and deposits and growth in personal banking, notably in our mortgage portfolio and good market share gains in consumer loans.

Our commitment to delivering for our customers is yielding dividends for our shareholders marked by the eighth consecutive quarter of strong revenue growth.

P&C US results reflect the economic environment in which we are operating. At this time, our objective continues to be to effectively position P&C US for growth as business conditions improve. To this end, we are executing on the integration of the FDIC-assisted transaction in Rockford, Illinois. We have completed the branch rationalization and the headcount reduction plan. The next milestones will be the replacement of all signage and the technology conversion in September. We are seeing good client and deposit retention, as well as growth in deposits and checking accounts.

We are replicating strong offers across the Company. In June, we introduced Harris Helpful Steps to the US market. It's an extension of a program that has worked remarkably well in Canada and as expected, we are seeing early and positive response. And in commercial banking, we built a business model that focuses on specialized coverage of seven business segments where we have expertise. This sets the stage for faster growth in key markets, broadening our footprint and establishing brand leadership.

We are going into the economic recovery with an energized US management team, an enhanced business structure and ramped up visibility of the strong Harris brand, all good positions to be in.

Net income in the Private Client Group was $108 million with growth across most of our businesses. Assets under management and administration improved 11% year over year after adjusting to exclude the impact of the weaker US dollar. We continued to strategically invest in the business, increasing our sales force and enhancing our product offers. We continue to pioneer in the ETF sector, we launched eight more ETF's in the quarter, expanding our product line now to a total of 30 funds.

As mentioned earlier, BMO Capital Markets' Q3 results were down from recent levels with net income of $130 million. The trading environment was considerably weaker and economic conditions negatively affected results. Our Q3 results also reflect the negative impact of widening credit spreads. Year-to-date, Capital Markets has performed well, delivering net income of $604 million. We are continuing to build our capabilities, including key hires where we have taken advantage of the current conditions to build our team for the long-term. This is positioning us for growth across key sectors as the market environment improves.

I would like to spend a few minutes updating you on capital and regulatory reform and their impact on BMO. A number of open items are expected to be resolved as we move towards calendar year-end. These include the final calibration of regulatory targets and the role, if any, of contingent capital or a countercyclical buffer. We understand that the global framework will provide an appropriate transition period to ensure that the new rules, once implemented, don't jeopardize the recovery.

Based on what we know, and the work we have done to date, we are well positioned on both an absolute and relative basis to adopt the new rules. Our prudent strategy of maintaining elevated capital and liquidity levels now positions us well to execute our growth strategy and take advantage of opportunities going forward.

To that end, our Tier 1 capital ratio at the end of the quarter was 13.55% and our tangible common equity to risk weighted asset ratio was 10.4%. We continue to assess the impact of the Dodd-Frank Act, which is complex and broad in scope with many aspects subject to rulemaking and implementation over several years. We anticipate increased regulatory costs, but think reform will be to the advantage of well-capitalized banks. As you know, BMO views the current environment as an opportunity to strategically expand our US footprint. We are carefully monitoring all capital and regulatory changes that would impact that strategy in any way.

Before wrapping up, I want to note that BMO is now carbon neutral with respect to energy and transportation worldwide. This fulfills a commitment we made two years ago. I would like to give special thanks to our employees who have made sustainability a priority at BMO. They have made meaningful contributions to reduce carbon emissions by changing work day habits and routines. Those efforts combined with the purchase of renewable energy and our investment in high quality carbon offsets got us to today's announcement. We are proud to be doing our part for a sustainable future for everyone.

In summary, BMO will continue to benefit from our strong diversified business mix. In fact, we are well positioned to increase the pace of growth. The regulatory environment is manageable. Recent economic news suggests slower business activity, however, GDP is still expected to remain positive, supporting our planned business growth. P&C Canada and PCG are producing very good results. Management at P&C US and BMO Capital Markets are positioning their businesses to benefit as the US economy gradually improves. We expect credit performance to continue to improve with some quarterly variability and our balance sheet is strong and we are committed to growth. And with that, I'll turn it over to Russ.

Russ Robertson -*BMO Financial Group - CFO*

Thanks, Bill and good afternoon. As some of my comments may be forward-looking, please note the caution regarding forward-looking statements at the beginning of the presentation.

On slide 9, you can see the third quarter earnings were $669 million, or $1.13 per share. Return on equity was 13.7% and our Tier 1 capital ratio remains very strong at 13.55%.

On a year-to-date basis, net income was $2.1 billion and return on equity was 14.8%. Credit continued to show improvement in the quarter with quarterly provisions of $214 million, which Tom will speak to shortly.

Turning to slide 10, revenues were down year-over-year and quarter-over-quarter mainly due to significantly lower trading revenues in capital markets more than offsetting growth in our other businesses. Net interest income was $1.6 billion in the quarter, up $105 million, or 7% from a year ago, driven by strong growth in P&C Canada and improvement in Corporate Services offset in part by a reduction in Capital Markets.

Quarter over quarter, net interest income increased $49 million or 3% due to additional days in the current quarter and increased margins in our P&C businesses. The total bank net interest margin was up 14 basis points year over year due to increases from our P&C businesses. P&C Canada benefited from higher spreads in deposit products while improved loan spreads and deposit balance growth helped P&C US margins. Better net interest income in corporate services also contributed to the improvement. Quarter-over-quarter margins were unchanged as increases in our P&C businesses were offset by reduced net interest income and corporate services and decreased spreads on trading assets in capital markets.

Turning to slide 11, year-over-year expenses increased $25 million, or 1%. The main drivers of the increase are from our recent P&C US transaction, increased initiative spending and higher provincial sales tax. These increases were partly offset by a weaker US dollar and lower employee costs due to reduced performance-based compensation. Quarter-over-quarter expenses increased $68 million, or 4%, driven by additional calendar days in the current quarter, as well as an increase in our investments in technology, higher professional fees, provincial sales taxes, capital taxes and costs of the acquired businesses. These were offset by slightly lower performance-based costs and severance. We remain focused on managing our expenses and this is a priority across all of our businesses. That said, we will continue to invest in our business to advance our strategic agenda.

On slide 12, you will see that our risk-weighted assets were $157 billion at the end of Q3. While our risk-weighted assets increased in P&C Canada, they were down $2.5 billion over last quarter at a total bank level. The decrease can be attributed to lower corporate and commercial risk-weighted assets and lower other credit risk assets. Our Tier 1 capital ratio is now 13.55% in the quarter and is expected to remain strong going into fiscal 2011. The tangible common equity to risk-weighted assets ratio also increased to 10.39%. Our strong capital position provides flexibility in the execution of our business growth strategies and positions us well for the pending regulatory changes.

Moving to slide 15, P&C Canada had another strong quarter. Revenue increased over the prior year driven by volume growth across most products, the inclusion of Diners Club revenues and improved net interest margin. Volume growth across most products, improved margins and additional days benefited comparisons for the second quarter. Cash operating leverage was a strong 5.5% and the cash productivity ratio remained at 51%.

Turning to slide 17, P&C US results continue to be impacted by the elevated levels of impaired loans and the cost to manage them. In addition to increased loan spreads benefiting revenues, the inclusion of AMCORE increased revenues and expenses, including integration costs, each by US$18 million. We expect integration costs to be higher in the fourth quarter.

Turning to slide 18, our Private Client Group results were down $5 million from a year ago. Last year's results included a $23 million recovery in prior periods' income taxes. There was solid growth across most businesses driven by an improvement in client assets under management and administration. Revenue from the insurance business was down overall as growth from net premiums was more than offset by the effects of unfavorable market movements on policyholder liabilities. Expenses remained essentially flat as higher revenue-based costs were offset by active expense management.

BMO Capital Markets' results were lower this quarter due to lower trading revenue compared to a very good trading performance in the past four quarters. Trading revenues in the second quarter benefited from tightening credit spreads whereas credit spreads widened in Q3 negatively impacting trading revenues. In addition, trading margins were lower. This was partially offset by higher revenues from our interest rate sense of the businesses and increased debt underwriting fees. The weaker economic conditions for corporate banking also contributed to lower revenues year over year.

On a year-to-date basis, revenues in Capital Markets have increased $170 million, or 7.4%, largely due to improved M&A activity and debt underwriting fees and investment securities gains versus losses in the prior year, partly offset by decreases in our interest-rate-sensitive businesses, corporate banking net interest income and trading revenue. ROE is strong at 18.4% on a year-to-date basis.

Finally, on slide 22, corporate services results continued to benefit from lower provisions for credit losses under BMO's expected loss methodology.

In conclusion, our results reflect a quarter of solid earnings driven by continued good results from Canadian retail and improved credit performance. With that, I will turn things over to Tom.

Tom Flynn - *BMO Financial Group - EVP & CRO*

Thanks, Russ and good afternoon. Before I begin, I draw your attention to the caution regarding forward-looking statements. I will start with slide 25 where we provide a breakdown of our loan portfolio. The portfolio is well diversified both geographically and by segment. 75% of loans are in Canada and 20% in the US. Consumer loans represent 60% of the Canadian portfolio and 86% of these are secured. Our US portfolio mix is 43% consumer and 57% commercial and corporate.

Slide 26 provides details on our US loan portfolio. As we have discussed in previous quarters, losses on this portfolio are higher than those in Canada. The portfolio represents 20% of total loans, is well diversified and our underwriting practices were more conservative than the industry overall resulting in lower provisions.

The US consumer portfolios are relatively evenly spread across first mortgages, home equity and auto loans. These portfolios have been impacted by weak labor and real estate markets. But all three segments have continued to perform better than the industry. The C&I portfolio is well diversified and is performing reasonably. As you know, the US commercial real estate sector continues to experience weakness. Based on current trends, we're not expecting this market to improve in the near term. The sector represents $3.5 billion, or 2% of total loans. The portfolio is $3.1 billion, excluding loans acquired in the second quarter and covered by the FDIC loss share.

Investor-owned mortgages represent approximately 5% of the US portfolio and the developer portfolio is approximately 2%. The investor-owned mortgages are mostly confined to our Midwest footprint, are well-diversified by property type and were underwritten prudently. This portfolio continues to experience negative migration given market conditions. The developer portfolio has continued to reduce and is under $1 billion in size. This portfolio was impacted early in the downturn and we believe that migration here has peaked.

Turning now to slide 27, the chart shows information on impaired loan formations for the quarter. Formations were better than expected at $242 million, down from $366 million in Q2. The US portfolio continues to account for the majority of formations at $185 million and were diversified across sectors with commercial real estate related making up the largest portion at 39%. Within Canada, formations were diversified across a number of sectors.

Gross impaired loans were down to $3.1 billion from $3.4 billion last quarter. Excluding impaired loans associated with our Q2 acquisition, which benefit from the 80/20 FDIC loss share, impaired loans declined to $2.8 billion from $3 billion in Q2.

Slide 28 provides details on the provision for credit loss. The consolidated specific provision was better than expected at $214 million, down from Q2, which was $249 million. While the big picture downward trend in both provisions and impaired formations is clear and positive, performance quarter to quarter still clearly has the potential for variability given the weak recovery and the extent to which provisions in the last two quarters have benefited from low capital market provisions and recoveries.

Moving now to the business segment details that are shown in the table, the P&C Canada provision improved this quarter largely due to lower commercial provisions, which were down as expected from a high level in Q2. P&C US provisions were relatively flat quarter over quarter with the increase in commercial provisions largely offset by a decrease in consumer. Provisions in this segment are expected to continue to be impacted by weak real estate markets and high unemployment. Lastly, Capital Markets provisions again this quarter were in a negative position or a recovery position benefiting from low new gross provisions and recoveries. In general, the Capital Market portfolio continue to stabilize as larger companies take advantage of better markets to strengthen their balance sheets and are generally more resilient.

Turning to slide 29, you can see a segmentation of the provision by geography and sector. The Canadian provision was $110 million, down from $139 million in Q2. The Consumer and Credit Card segments continued to be the largest drivers of the Canadian provisions. The US provision was $104 million, down $19 million from Q2 due to lower consumer and corporate provisions. The Consumer segment continues to represent the largest segment of US provisions. That concludes my presentation and we can now move to the Q&A.

QUESTION AND ANSWER

Operator

Darko Mihelic, Cormark Securities.

Darko Mihelic - ***Cormark Securities - Analyst***

Hi, good afternoon. This is a question for Frank Techar. Frank, when I look at the results you are posting, it seems like you have had a real positive improvement in the margin for some time now and even this last quarter caught me a bit off guard. Can you talk to where the improvement is coming from and why we should think of the margin as at least stable? Or maybe perhaps another way of thinking about this is do you think it could improve any further?

Frank Techar - ***BMO Financial Group - President & CEO, P&C Canada***

Thanks Darko, we were happy with the margin improvement this quarter in support of our 9% revenue growth and it was a contributing factor. I think when you think about the performance of our net interest margin, the biggest reason that we are seeing the continued strength has to do with the mix in the portfolio. If you look at the balance sheet growth in Q3, we had very strong growth in our high spread loan products. We had faster growth in our consumer loans. We had faster growth in our commercial loans than we had seen in previous quarters and so that contributed to the margin improvement as well.

On top of that, we have not seen our deposit growth decline as much as we had expected as we have gone through the year. We thought consumer preferences were going to change as the economy improved and our deposit growth, both on the commercial side and the retail side, our core operating deposits have both been in excess of 10% for the last couple of quarters. So the combination of faster growth in higher spread loans plus continuing strong growth in our core low interest rate deposit products are resulting in the margin just staying as strong as it has been.

In the quarter, we also had a little bit of help from some mortgage refinancing fee business as well. So that helped us out. But my expectation going forward for margin is that we should be able to hold our margins in and around the 290 level, which we saw. I suspect there will be a little bit of volatility depending on some of the non-core things, but we are expecting our high spread product growth to continue.

And if you look at the balance sheet growth this quarter, the sequential growth in loans and deposits, and you annualize both of those, the loan growth is over 9% and our deposit growth is over 6%. So we think that the balance sheet mix, the change in mix as we continue to move forward is going to continue to benefit the margin.

Darko Mihelic - ***Cormark Securities - Analyst***

Okay, thank you. And maybe just one more question. I would be remiss to not touch upon trading. So the question is for Tom. With respect to trading, can you talk to the weakness that we saw in the quarter, particularly in the fixed income side and talk to us about what kind of run rate we should be using or thinking about for your business?

Tom Milroy – *BMO Financial Group - CEO, BMO Capital Markets*

Okay, Darko, thank you. Obviously, the third quarter was a disappointment. It didn't meet our expectations after two quarters that were particularly strong. In the quarter, we experienced more volatility, increased client uncertainty and fewer opportunities. So if you look at page 12 of the supp pack, you will see that the greatest decline came in the interest rate trading area. And there was what I would group as sort of two broad factors. One was credit spreads and the other was our fixed income business.

In terms of credit spreads, widening credit spreads negatively impacted a number of positions we had in some of our non-core businesses. And those were the same positions that we had seen positive marks in Q2. We saw a negative in Q3 and it is obviously the delta is larger, and it amplifies the impact when you have gains followed by a loss.

The other thing that happened in terms of credit spreads would be increased CVA charges resulting from the fact that, in general, the spread between our credit spread and our counterparties widened. So those two factors were significant and probably accounted for almost 60% of that decline you see.

The last major piece of it, which was the fixed income business, just had a poor outing in the quarter and we saw both narrowing margins and client trading activity…and frankly, fewer trading opportunities.

Darko Mihelic - *Cormark Securities - Analyst*

And so on a go-forward basis, how should we think about that? Has that spread impact abated already in Q4 or what can you offer us on that front?

Tom Milroy – *BMO Financial Group - CEO, BMO Capital Markets*

May was a particularly weak month. Both June and July were better. So we have seen some improvement in that already. And I can't forecast for you the exact amount you should put in there. But I think if you look backwards and you look at some of the historical results, clearly, we wouldn't expect to see a repeat of Q3 in Q4.

Darko Mihelic - *Cormark Securities - Analyst*

Okay, thank you.

Operator

Sumit Malhotra, Macquarie Capital.

Sumit Malhotra - *Macquarie Capital - Analyst*

Good afternoon. Two net interest income related questions. Let's stay with Frank for the first one. The one area you didn't mention in answering the last question was the impact of the increases in the prime rate and not for the full quarter, but you did get 50 basis points of hikes in Q3 from the Bank of Canada. Can you talk about how that impacted the five basis point increase? And specifically, Frank, I think you were one of the first executives to mention that while rate hikes in theory should help, some of that will be eaten away by competition. So just want to know how that impacted the quarter and how you see that going forward?

Frank Techar *- BMO Financial Group - President & CEO, P&C Canada*

I think the rate hikes were not a big factor in the improvement in margins for this particular quarter. I think as I described the change in mix and the mortgage refinancing fees were the two biggest reasons. So I think what I have said in previous quarters were, all those things being equal, if rates go up, it should help, but that we were anticipating also some competitive pressure in the marketplace relative to price and doing business. And I think the increase in the prime rate basically got absorbed through the competitive dynamics. So the two reasons I have described are the real two reasons we saw the improvement this quarter.

Sumit Malhotra *- Macquarie Capital - Analyst*

Alright. And the second part of my question is probably best answered by Bill Downe. Bill, you have mentioned a few times on these calls that, in your view, the economic recovery would be driven on the business side. Specifically you've talked about that in relation to your US commercial lending mandate. When I reconcile that with your comments about the step back in economic growth over the last few months, how are you feeling about that business-led recovery or the corporate and commercial opportunity for BMO on the business side in 2011?

Bill Downe *- BMO Financial Group - President & CEO*

Thanks. I think to some extent, the slightly slower rate of growth in the latter half of 2010 doesn't really interfere with 2011. 1.5% GDP growth is positive growth. I think that we have to look to export expansion from the US market as a driver and that is why it is a business-led recovery. And we still have confidence in that. I think that it will probably first show up, simply in credit utilization. There is a lot of committed credit available. Balance sheets are very clean. There is a lot of cash in the hands of corporate America. It numbers in the trillions of dollars of cash and cash availability.

So I think that when you start to see a pickup in capital investment, which I think is inevitable because it has been stalled, we'll see first greater utilization. The one thing that our push in commercial banking in the last six months in the US has shown is that we can open new relationships. We haven't seen much utilization from that activity. In fact, many of those lines aren't being used yet, but we do believe that they will be.

So I think it is a little bit of timing. If you go back a year ago, we all accepted the fact that it was liable to be a slow recovery and while I think everyone is prepared to put a probability on the so-called double-dip, I think it is still a low number. So maybe a delay of a quarter or two in terms of credit utilization, but we still think that this is where we are going to see very concrete signs of growth. And then I think it will follow into the consumer sector after that.

Obviously, on the consumer side, the overhang in the housing market is going to, for some period of time, keep consumers somewhat conservative. But even there, they are repairing their balance sheets. The savings rate, positive savings rate is having a very salutary effect on consumer balance sheets. So the quality of consumer credit will be better going forward.

And if you look at what is going on in the credit card market, transaction volumes in July and August seem to be pretty steady. So I don't think the consumer has gone on strike, but will be waiting for the business-led recovery to signal that better times are coming.

Sumit Malhotra - *Macquarie Capital - Analyst*

Thanks for your time.

Operator

Robert Sedran, CIBC.

Robert Sedran *- CIBC World Markets - Analyst*

Good afternoon. Viki, I'll be good. I am just going to ask one question. Russ, you mentioned expenses and I note that they were pretty meaningfully higher quarter over quarter and I couldn't tell from your comments if it was unusually high or if it was sort of sustainably high. I know you mentioned the impact of acquisitions and business investment, but is that a line where we can expect some relief next quarter or should we assume that the Bank of Montreal continues to invest and so that number is going to stay elevated for a while?

Russ Robertson - *BMO Financial Group - CFO*

Thanks, I am just looking at page 13 of the supp pack, and I guess the first comment I would make is, when you look back over the past two years, the expenses aren't, I would suggest, are not that elevated. We did bring expenses down a little bit towards the end of '09, but the $1,898 Million is not that different from what you have seen in prior quarters. So I wouldn't call it elevated per se.

But we are very focused on managing our expenses as we've said in prior quarters, and so we are very focused on the FTE count and I would say in that area, we did add quite a number of people this past quarter, but I think it is around 800 or so. But 80% of those are front-line revenue-producing individuals and that is certainly an intentional investment that we would do that.

In the supplier spend, we continue to really focus on that cost. But again, having said that, we are making a number of technology investments in our client experience and so that will continue.

And then in the area of just managing our travel and business development and personnel expenses, again, we are pretty hard-nosed about that, but we are out there doing business and we are traveling. So I wouldn't call it elevated, but I would think this level of expense you will see probably going forward because of the investment spend, which is very intentional to drive higher revenues.

Robert Sedran *- CIBC World Markets - Analyst*

Fair enough. I guess I was looking at it excluding performance-based compensation, which was down this quarter even as the total expense number was up. And I guess that is the reason why I would've said they were elevated because they didn't come down as performance-based numbers came down. Should we expect that the performance-based numbers have got a downward bias to them as well or will they be bouncing back? I mean are we kind of comfortable with the accrual that you have had so far this year or is there anything else that we should be looking for there?

Russ Robertson - *BMO Financial Group - CFO*

We are quite comfortable. We have accrued on an appropriate basis. And if revenues move back up, you will see that incentive compensation move back up as well.

Robert Sedran *- CIBC World Markets - Analyst*

Okay, thank you.

Operator

Mario Mendonca, Canaccord Genuity.

Mario Mendonca *- Canaccord Genuity - Analyst*

Good afternoon. Probably for Bill. There have been a number of articles recently, essentially speculation on where BIS will come down on -- where they will come down in terms of the calibration on a particular capital ratio, whether it is 4 to 6 with a 2% capital conservation buffer. Is there anything you can provide, any insight you can provide on where you think the calibration will come down and anything along the lines of what a phase-in period might look like?

Bill Downe - *BMO Financial Group - President & CEO*

Mario, thanks for the question. I think that we are getting pretty good transparency from both the BIS and from the regulators in coming out and talking about where the consensus is forming, that the trend since last December I think has been a moderation of what I would have thought were some unrealistically hawkish positions. And so I think as the refinements work through, and we are really looking at three or four months, I think those refinements are going to be made with one eye on how much capital is necessary fully through the cycle and it may moderate a little bit more because the other eye is going to be on economic growth and the importance of maintaining economic growth.

And without giving too much credit to the process, I think it is working reasonably well. So from our starting point, it looks to us as though we are very well-capitalized. And I think that the run-in period -- actually the guidance has been relatively general, but I think if you look at European banks in particular, they are going to need an extended time period. I think that extended time period will apply to North American institutions as well.

So I do think that you'll probably see a little bit of further moderation. There is clearly some yet-to-be-had discussions about the notion of contingent capital and how some of those structures might work. And I think that is really somewhat open-ended. But you might want to think about Tier 1 versus total capital. And I think it is the difference between Tier 1 and total capital where there may be some advancements, some new thinking that has yet to emerge.

But I think right now, the best capitalized banks are being very cautious about saying they have surplus capital. In the resolution of the final talks, I think we will probably be able to look at with a higher degree of confidence that we have growth capital both for organic growth and for some acquisitions.

Mario Mendonca ***- Canaccord Genuity - Analyst***

Just a follow-on question, is it your feeling then, because I think most people would agree that BMO is one of those banks in a strong capital position. Is it your view that OSFI may be able to relax any kind of restrictions on dividend increases in 2011?

Bill Downe - ***BMO Financial Group - President & CEO***

I wouldn't put that at the feet of any supervisor. I think that recognizing that there is going to be a global framework; It is prudent in any jurisdiction to conserve capital until you know what the rules are. But the earning power -- we look at the earning power of the bank and if you look at our payout ratio, it has moved back towards our range and we were outside the range for some period of time. Once you get back into the middle of the range, I don't think, from a timing perspective, and you are talking about over two to four quarters, I don't think there will be restrictions that will get in the way of dividend increases at that point.

Mario Mendonca ***- Canaccord Genuity - Analyst***

So you said you don't think there would be any restrictions?

Bill Downe - ***BMO Financial Group - President & CEO***

No, I don't think so. I think this time next year, it will be very clear what the capital structures are and the earnings power of the bank will have put us in a different place.

Mario Mendonca ***- Canaccord Genuity - Analyst***

That's helpful. Thank you.

Operator

John Aiken, Barclays Capital.

John Aiken ***- Barclays Capital - Analyst***

Good afternoon, Bill. Carrying on with the deployment of capital theme, we have seen BMO's risk-weighted assets decline for six straight quarters. When do you become comfortable with I guess reinvestment of capital in the business? Is it Basel III or are you looking at IFRS? And as a follow-on to that, are you happy with how the FDIC deal has gone and would you look towards that as a way of expanding your footprint or would you look to more normal M&A acquisitions?

Bill Downe - ***BMO Financial Group - President & CEO***

Thanks, John. I have to compliment you**…**

John Aiken - ***Barclays Capital - Analyst***

That was three, wasn't it?

Bill Downe - ***BMO Financial Group - President & CEO***

You managed to make a large list of questions into one very neatly packaged question. And Viki will put a little star next to your category on that one.

John Aiken - ***Barclays Capital - Analyst***

Well, Bill, you can choose which ones you want to answer then.

Bill Downe - ***BMO Financial Group - President & CEO***

No, I am happy to give you an omnibus answer. You are right about the decline in assets and a lot of that has to do simply with credit utilization. As I said earlier, I think you're going to see a natural pickup in asset growth as existing commitments start to be used in a more normal way. So I do think we will see organic growth there.

The acquisition of the bank in Rockford and Madison I think is a good example of how infill expansion really can be beneficial. We essentially opened ourselves up to a much larger group of potential personal and commercial customers. We didn't just buy assets. It is access to those customer bases. And we have been able to rationalize branches and people in that process. So it should clearly be more profitable than what a legacy business would look like. So I think it is very attractive.

One thing that you have seen is the FDIC has gone a little bit quiet for the last 60 or 90 days. I don't think that is because of lack of supply. I just think there is some absorption that has taken place and it is just a question of people capacity. You can't resolve these banks without having people free to do it and they have come through quite a period actually of resolution of banks. So I think there should be some opportunity there. Those are very attractive transactions. It is not just the notion of buying something cheap. It is access to high-quality markets. So I think that does provide an opportunity to stimulate growth. I think I got three parts and I don't know if I missed something in the middle.

John Aiken - ***Barclays Capital - Analyst***

No, you covered them all. Thanks, Bill. That's helpful.

Operator

John Reucassel, BMO Capital Markets.

John Reucassel - ***BMO Capital Markets - Analyst***

Thanks. Bill, I just wanted to clarify your answer to Mario's question on dividends. Did you say that it would become clearer on BMO's ability to raise the divi in two to four quarters? Is that what you said?

Bill Downe - ***BMO Financial Group - President & CEO***

John, we are going to get into a level of precision here that I would prefer not to because I don't want to make you uncomfortable or me uncomfortable. What I intended to say was that the dividend payout has come back close to the target range, until there is clarity around capital standards, maintaining higher levels of capital makes a great deal of sense, but that we look to the increase in the earning power of the bank to bring the dividend well within the payout range. And when it is well within the payout range consistent with what we have said, our objective is to grow our net income and to grow our dividend, I think that is the timeframe when we would start to talk more about that.

John Reucassel - ***BMO Capital Markets - Analyst***

Okay. So I think your previous range was around 50%, 45% to 55%, correct me if I'm wrong. So the new kind of regulatory backdrop, does that payout ratio range have to come down? It seems like there are some disincentives on high payout ratios coming out of these Basel documents. Is that interpretation fair and could you talk about your longer-term payout ratio?

Bill Downe - ***BMO Financial Group - President & CEO***

I think it's the relationship between growth opportunities in the business and dividend growth because it really does swing on the amount of capital that you want to maintain. And as you know, it is arithmetic; it drives right out of the earnings of the bank. So at the time that we increased our payout range from 40% to 50% where it was to 45% to 55%, the acquisition opportunities were very constrained because basically the market was pricing acquisitions at three times book and we thought that a higher distribution at that time made sense.

So I think you have to roll forward a year and say where do you think you will be able to find organic growth that is profitable and will there be good opportunities for reinvestment. And that is the time at which you would say that you might amend the objective around payout. But if I was a shareholder or if I was an analyst, I would be focused more on growth in the dividend itself and not too bound by what the payout ratio might have been in the past or what our previously declared range relative to the other banks would be. I don't think it is that significant a boundary personally.

John Reucassel - ***BMO Capital Markets - Analyst***

Okay. To Frank Techar, the outlook for consumer loan growth in Canada, has your view changed in the last quarter or so given the slower economic growth and housing stats? Could you give us a sense of what you expect from BMO or from the industry as you look forward?

Frank Techar - ***BMO Financial Group - President & CEO, P&C Canada***

Yes, John, we have had really strong growth the last couple of quarters, stronger this quarter again. The primary reason for the growth is two products. One is our Homeowner ReadiLine product (HRLC) and the other is our auto loans. Both of them obviously secured, both of them we are really happy with. And the HRLC product the way we look at it is really a substitute for other mortgage products. And so to the extent we see a tail-off in the mortgage business, it is likely we might see a bit of a decline in our HRLC business going forward.

Having said that, our objective is to continue to grow share in this product category. It is obviously an important product to us and our investment agenda is focused on continuing to grow. So, as Russ mentioned earlier, through putting more people into our branches, focusing, being more competitive in our distribution network, we are going hard at the marketplace. So I think our strategic agenda is positioned well to offset any decline that we might see in the market itself.

John Reucassel ***- BMO Capital Markets - Analyst***

Okay. Thank you.

Operator

Michael Goldberg, Desjardins.

Michael Goldberg ***- Desjardins Securities - Analyst***

Thanks. I have two questions. First of all for Bill, if the contingent capital proposal from the Basel committee that just came out recently is implemented, what do you think the impact will be and how would you adapt?

Bill Downe - ***BMO Financial Group - President & CEO***

Michael, consistent with what I said a minute or so ago, I think that it really is going to be a discussion about the value of the difference between Tier 1 and total capital. And so contingent capital will fit into that zone. And the issue around contingent capital will be how to structure in a way that is both cost-effective and has appeal to investors. And I think you'll have to look at innovative Tier 1, at sub debt, and at pref shares to think your way through where the market would be.

My own view is that there is a place in the market where you will be able to issue capital in this category. We don't know where it will price and the pricing will determine how much you do. One way you might want to think about it is the idea of a total capital ratio, which might allow a portion of the capital to be contingent and if the market wasn't there, then I guess it would have to all be common.

Michael Goldberg ***- Desjardins Securities - Analyst***

Right.

Bill Downe - ***BMO Financial Group - President & CEO***

That’s the way you could think about it.

Michael Goldberg ***- Desjardins Securities - Analyst***

Right, okay. And my second question is if you could give us your view of how you expect reform of the US home finance process to develop. I guess an issue that seems to be at least getting started if not in process now.

Bill Downe - *BMO Financial Group - President & CEO*

I think there is a commitment on the part of the President to get started in January. I am sure that, at this point, he wished he had said he was going to get it underway by January of 2012 because I think allowing a little bit of time will make it easier for that adjustment. I think it all relates to the structure of the housing market and you can make all kinds of comparisons between the Canadian housing market and the US housing market and whether tax deductibility of mortgage interest makes sense. The degree to which Fannie and Freddie have to be direct participant in the market or whether they can be guarantors and I think it will take some time for that debate to take place.

So I would look for all of 2011 for there to be a discussion around the resolution of the market and it will only be eased as the housing market stabilizes and you start to see a firmer floor under house prices.

Michael Goldberg - *Desjardins Securities - Analyst*

So you think it is going to take an extended period of time before there actually is even some clear idea of how it is going to go or do you think that, in January, there is a proposal that emerges that could be the basis of how it is going to go?

Bill Downe - *BMO Financial Group - President & CEO*

Well, this could go on past the end of this call, but the mid-term elections will determine the temperature of those discussions. But I suspect that the President said he was going to get started on it in January, he will start forming the committee in January. So I think you'd see an extended period of time and I don't know what rush there would be. The objective I think is to get something done, but I don't think there is a red hot hurry.

Michael Goldberg - *Desjardins Securities - Analyst*

Thank you.

Operator

Andre Hardy, RBC Capital Markets.

Andre Hardy - *RBC Capital Markets - Analyst*

Thank you. Can you please talk about your view of a normalized tax rate and also talk about what took the tax rate from the 20% range to the 13.5% range in the quarter?

Russ Robertson - *BMO Financial Group - CFO*

It's Russ. Certainly, as you know, our effective tax rate benefits from income earned in low tax rate jurisdictions and also benefits from transactions we do to facilitate on a tax-efficient basis with our clients. In Q3, those tax-efficient transactions probably improved with the delta of 5% or so from the 18% down to 13%. But I would also add that our lower pretax income in Q3 does make our income earned from low tax jurisdictions more of a factor in the effective rate, which does bring it down as well. It is essentially the tax-efficient client transactions that took it from 18% down to 13%.

Andre Hardy ***- RBC Capital Markets - Analyst***

But these transactions are helping or hurting your revenues?

Russ Robertson - ***BMO Financial Group - CFO***

Helping.

Andre Hardy ***- RBC Capital Markets - Analyst***

So you have a plus on the revenue front and a low tax rate?

Russ Robertson - ***BMO Financial Group - CFO***

We reflect, as you know, on a tax-equivalent basis and you can see that in Corporate. You can see the TEB gross-up in Corporate and the offset would be in the group.

Andre Hardy ***- RBC Capital Markets - Analyst***

Sorry, Russ. I guess I was looking at it on the $2.9 billion of revenues, not doing tax affecting.

Russ Robertson - ***BMO Financial Group - CFO***

You would not, no, we reverse that out at a total bank level.

Andre Hardy ***- RBC Capital Markets - Analyst***

So at that level, that would have hurt or helped revenues?

Russ Robertson - ***BMO Financial Group - CFO***

Total bank level, it would be neutral. It doesn't affect revenue; you just see it in the tax line.

Andre Hardy ***- RBC Capital Markets - Analyst***

Okay. So if I am normalizing your numbers for tax, all I am doing is taking that 13% to 20% and there is no revenue impact?

Russ Robertson - ***BMO Financial Group - CFO***

Right.

Andre Hardy - ***RBC Capital Markets - Analyst***

Thank you.

Operator

Steve Theriault, Bank of America-Merrill Lynch.

Steve Theriault - ***Bank of America-Merrill Lynch - Analyst***

Thanks very much. A couple questions. Bill, we have talked a lot about dividend increases. Can you refresh us on your thoughts on the potential for buybacks once the regulatory air clears? Would you entertain a buyback before increasing the dividend?

Bill Downe - ***BMO Financial Group - President & CEO***

We have an ordinary course issuer bid in place. It is a helpful tool to offset small amounts of dilution. To me, it is a business-as-usual capability and barring the current situation where you're really waiting for regulatory clarity, there is no reason why, once you had regulatory clarity, it wouldn't be incorporated. I think it is a little different than the dividend increase just because it tends to be small amounts at really an opportunistic moment in time. So I don't see buybacks as a big factor in total capital. But I'm putting a little bit of a fine point on it and I think that was really your question.

Steve Theriault - ***Bank of America-Merrill Lynch - Analyst***

So just offset small amounts of dilution really?

Bill Downe - ***BMO Financial Group - President & CEO***

Yes.

Steve Theriault - ***Bank of America-Merrill Lynch - Analyst***

Okay. And just a quick one for Ellen. With the AMCORE acquisition, the productivity ratio jumped to over 70% this quarter. Is that going to be a fact of life for a little while or are there things you can do in the near term to get back down below the 70% level?

Ellen Costello - ***BMO Financial Group - President & CEO, P&C US***

Actually, yes, we have announced the headcount cuts that we plan to execute between now and the end of the year and that is about half of the workforce [acquired from the transaction]. So that will bring our expenses down quite a bit as we head into Q1. And also, I think Russ touched on this, we do expect a fairly significant acquisition integration cost in Q4, but you will see a normal run rate for the business at the start of the fiscal year. I don't know if that answers your question completely.

Steve Theriault - ***Bank of America-Merrill Lynch - Analyst***

And the normal run rate closer to what it was a couple of quarters ago?

Ellen Costello - ***BMO Financial Group - President & CEO, P&C US***

Yes, that's right because if you factor out AMCORE, as well as the MSR adjustment, you would find our expenses are flat over the last year.

Steve Theriault - ***Bank of America-Merrill Lynch - Analyst***

That's helpful. Thank you.

Operator

Brian Klock, KBW.

Brian Klock - ***Keefe, Bruyette, Woods - Analyst***

Good afternoon and thanks for taking my questions. I guess, Tom, this question is for you. The credit trends continue to improve and actually when I look at the gross impaired loan formations, they were very positive, especially in the US when we look at construction in the commercial real estate portfolio. Just want to make sure. It sounded like from your comments that you are kind of hedging your bets a little bit saying it seemed like there may be some lumpiness. Was there anything that you were seeing maybe post end of the quarter that makes you kind of think that the gross impaired loan trends and formation trends may be a little lumpy going into the fourth quarter?

Tom Flynn - ***BMO Financial Group - EVP & CRO***

There is really nothing happening post quarter end that is influencing our view and to me, the comments that I made this quarter related to just noting an air of caution related to the potential for variability are similar to the comments that I made a quarter ago. And provisions are down this quarter, are down more than we thought they would have been a quarter ago. And like last quarter, this time around, we benefited from very low provisions on the capital market side and elevated level of recoveries. And so given where we are in the cycle, the fact that there are still challenges in the US and there is the potential for one or two larger credits to jump up on the capital market side, we just want to caution people that the steep downward trends that we have seen may not repeat quarter after quarter.

That said, the general trend backing away from quarter-over-quarter performance we think is clearly positive and delinquencies are trending down, the Canadian portfolios are performing well. Capital market portfolios are performing well and the weakness that we have got in the US is reflective of the environment. And we need a little more time for the employment rate hopefully in the US to come down and housing to stabilize. And with that, we will be more confident about a lower run rate on the credit side.

Brian Klock - ***Keefe, Bruyette, Woods - Analyst***

Okay, great. And actually, Viki, you'll be happy. Most of my other questions have been answered, so I am going to do one question and get back in the queue. Thanks, guys.

Operator

Cheryl Pate, Morgan Stanley.

Cheryl Pate ***- Morgan Stanley - Analyst***

Good afternoon. I have a question for Ellen on the net interest margin in the US. And trying to think about how much of the margin improvement this quarter was driven by higher loan spreads, how much do you do loan repricing versus new loans going on at higher spreads and how much we can expect that to continue? Another way to say it is how much of the loan book still has to reprice? And thinking about the margin on a normalized basis going forward, there has been a couple acquisitions, some movement of corporate loans into the portfolio. How should we think about the margin going forward and eventually moving into a rising rate environment down the road in the US as well?

Ellen Costello - ***BMO Financial Group - President & CEO, P&C US***

Thanks for the question, Cheryl. I would say that there are three drivers of the margin improvement. One is the loan spreads that you touched on and that is a function of both renewal credits and new originations that are coming in at higher spreads and improving the overall spread on our books. Also, our deposit growth has been very much centered in core deposits, which are more attractive from a spread perspective. Even though we have depressed margins and deposits, that growth is outpacing some of the margin impact. And then lastly, we do have a smaller loan book that the margin is reflective of. So that is a factor. As the loan book normalizes, you will see some normalization of that spread probably coming down a bit. And then I think -- I don't think we are going to see increased interest rates for a while. So certainly when we do, we hope that we will see some improvement in that depressed margin from a deposit perspective.

Cheryl Pate ***- Morgan Stanley - Analyst***

And just as a quick second question, any update you can offer on the potential impact from some of the regulations coming into the U.S., particularly Reg. E, and any mitigation opportunities that you could implement as well?

Ellen Costello - ***BMO Financial Group - President & CEO, P&C US***

That's another good question. Reg E doesn't have as much impact on us as other banks. We have about 5% of our households that are active overdrawers of their accounts and I would put a number on it of about US$25 million. So that is how small it really is on a relative basis compared to some other numbers you have heard in the market. We are looking to recover some of that by restructuring some of our checking products much like others in the industry are currently doing, as well as offering options to our customers like savings accounts, overdraft facilities, that type of thing. And some ability to opt in should they choose. So we think we should be able to partially recover, similar to the industry, 50% to 60% of that fee loss.

Cheryl Pate ***- Morgan Stanley - Analyst***

Thanks. That's very helpful.

Operator

Gabriel Dechaine, Credit Suisse.

Gabriel Dechaine *- Credit Suisse - Analyst*

Good afternoon. Just want to ask about your interest rate sensitivity. It looks like you were hurt more by a decrease than you benefit from an increase and that has switched around for the first time in the last few quarters. Can you talk a bit about your positioning, what you have kind of modeled as far as rate increases and what happens if rates stay flat in the US and in Canada possibly throughout 2011?

And then Tom mentioned something along the lines of non-core positions not benefiting from the spread widening that took place this quarter as opposed to spread tightening last quarter. Is that a referral to the prop book and if so, could you expand on that?

Tom Flynn - *BMO Financial Group - EVP & CRO*

It's Tom Flynn. I will start on that. In terms of general movement in spread, I don't think I would have a lot to add to the comments that Frank and Ellen have made where they talked about where the spread was going in the business. In terms of the sensitivity, the sensitivity of earnings to a 100 point decrease in rates increased in the quarter as you pointed out. That is in the supp pack and the larger negative number there really reflects the consequences of prime rate increases in Canada. And with a 50 basis point increase in the Bank of Canada rate over the quarter, there is basically more room for rates to move down than there was before and that creates more exposure when you shock the rates down 100. So it wasn't a positioning thing, it was just a result of the move by the Bank of Canada and how the model works.

Gabriel Dechaine *- Credit Suisse - Analyst*

And are you modeling rates to stay or go up at the midpoint next year?

Tom Flynn - *BMO Financial Group - EVP & CRO*

We think, in Canada, rates are going to continue to move up assuming obviously that the economy continues to do well and our expectation for US rates is that they won't start to move up until well into next year.

Gabriel Dechaine *- Credit Suisse - Analyst*

My question to Tom?

Tom Milroy – *BMO Financial Group - CEO, BMO Capital Markets*

Thanks Gabriel, I think just to be clear, we had a number of positions that are non-core positions that we hold and yes, we hold them for our own account, so I think you could consider them prop. What happened was that as spreads tightened in Q2, we marked those positions to market and resulted in gains and in Q3, it swung the other way and there were losses. And the point I made was when you have a gain followed by a loss quarter over quarter, the delta is the sum of the two.

Bill Downe - ***BMO Financial Group - President & CEO***

I think by way of clarification, Tom, you are talking about legacy assets.

Tom Milroy - ***BMO Financial Group - CEO, BMO Capital Markets***

Yes, legacy assets; A perfect example, and i wouldn't be telling you anything that is not in the market, but the position that we hold in the Montreal Accord paper.

Gabriel Dechaine - ***Credit Suisse - Analyst***

Okay, thank you.

Operator

Brad Smith, Stonecap Securities.

Brad Smith - ***Stonecap Securities - Analyst***

Yes, thanks very much. I guess this question is for Bill. Bill, looking forward and anticipating that there will be some investment opportunities in the US, I was just wondering if you could describe to me a little bit the formula or the approach that you take to evaluating prospects when they are brought to you by your operators? And specifically, I would like to talk a little bit about profit thresholds through cost of capital, which I believe has been held pretty steady at 10.5%. Would that be the same cost in the US or is that blended number different when you look there? And just talk a little bit about the return on assets in the US, which runs about 70% of your ROA in Canada. Where do you see that potentially going to through scale increase and things like that?

Bill Downe - ***BMO Financial Group - President & CEO***

Well, I will try to give you a brief answer on that one. We have a framework around acquisitions. It has worked pretty consistently for us. It is still looks at a hurdle rate, IRR hurdle rate of 15% and accretion in a relatively short period of time, three years or less. I think in this environment, we are looking for opportunities that are accretive immediately. I don't think that is going to be something that prevails for a long period of time, but we are much more driven by the relevance of the property to our business model, the way we serve customers and our existing footprint than anything else.

So if someone brings a once-in-a-lifetime transaction in a business that doesn't look like an existing business that is far away from where we do business or is an area where we don't have experience or knowledge, it is not really that relevant, we're not interested in it. So I think that we are looking for contiguous, similar acquisitions and mostly in the personal and commercial and wealth areas and we have an active group who is very busy in maintaining relationships in the hopes of something emerging.

On the capital markets side, less inclination to acquire businesses. We have been very fortunate in being able to attract high quality people and that has led to business extensions and a good example is the municipal bond business, where long heritage in the municipal bond business, has really been able to increase our presence in that segment of the market by adding talent. And it is really no change in the sense of the standards that we have or the discipline we have and the discipline served us well.

Brad Smith *- Stonecap Securities - Analyst*

Great. The one thing that I'm just trying to wrap my head around is when I look at the return on the assets in your US P&C bank, I know at their peak, they were doing 70 basis points on an annualized basis. In the latest quarter, it was less than 50. And I am trying to understand how, in that environment, any potential opportunity that came your way could be jammed into your 15% IRR. Is it just through your leverage assumption or how do you do that?

Bill Downe - *BMO Financial Group - President & CEO*

Well, the calculation that you made, has the burden of a very large impaired loan portfolio. So if you take an acquisition that was made with government assistance, the vast portion of the impaired loan portfolio you would be able to mitigate at the time you did the transaction. So I don't think they are comparable.

Brad Smith *- Stonecap Securities - Analyst*

Right. But back in 2007 and 2006 when you were generating 70 basis points on your invested assets in the US, there was no big impaired loan portfolio and I am still not sure how you can jam that into a 15% IRR. How do you make that happen?

Bill Downe - *BMO Financial Group - President & CEO*

I think that is a question that we probably ought to take off-line and sit down with a pad and paper and work through it.

Brad Smith *- Stonecap Securities - Analyst*

That would be helpful. Thank you very much.

Bill Downe - *BMO Financial Group - President & CEO*

There is no mystery to it, but I don't want to prolong the conversation. We have gotten to I think the limit that Viki allocated to us as management and I'm going to turn it back to her.

Brad Smith *- Stonecap Securities - Analyst*

Thanks.

Viki Lazaris - *BMO Financial Group - SVP, IR*

Great. Thanks, everyone, for joining us today and as always, please feel free to call the Investor Relations team and we can follow up on some of the questions. Thanks. Have a great day.