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CONFERENCE HOST

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Scotiabank Global Banking and Markets

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

My next guest is Mr. Darryl White, Chief Executive Officer of the BMO Financial Group. Darryl, good to see you.

Darryl White – Bank of Montreal – CEO

It's good to see you, Meny. And if I may say, thank you for hosting this conference. The show must go on, as we say. It's been a great conference for a long time, and I'm glad you guys have continued to lean into it. So thank you for having us.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

This is our first virtual conference. And hopefully, we'll get back into a face-to-face mode next year, but we'll make the best of it now, and properly social distanced.

Darryl, I wanted to start off with a broad question and kick off from the Q3 results, very, very good results for BMO in Q3. And I'm just hoping you could give us your take on the quarter and also your outlook as you head into the end of the year.

Darryl White – Bank of Montreal – CEO

I'm happy to start there, Meny. I don't, often in these conferences, like to focus on any particular quarter. But in this case, I'm happy to, not so much just because it was a good quarter. You're quite right. We are proud of it. We think it was a very good quarter. But more importantly, I think what it represents for us in terms of where we are in our journey and where we see ourselves going forward. So to your question, when I step back, I look at it, and this is us demonstrating effectively what we've been saying we would do. We've talked for some time about getting consistent performance across our businesses, and we saw that across all of our businesses in the quarter, and I'm happy to talk today about any one of them, if you wish. But the point is that we had a really strong, consistent performance across all our businesses, and we had noted improvement on our efficiency agenda. So we had 4% revenue growth year-over-year in the quarter, which we think in the environment was particularly good. And at that same time, we had 2% year-over-year decline in expenses. So we led to above 5% operating leverage. Our efficiency ratio at 56.8% is something that we think is notable and we're very proud of.

And as I said on the call for the quarter, Meny, I think what's most important as we think about how we frame this in our go-forward strategy, I think I said 4 things pretty clearly. So I'll repeat them more briefly here. But the first was the strong operating momentum in the businesses. And when we look across over the last several quarters, we think we're pretty close to best in class, frankly, on operating leverage and performance against the objectives that we set out a couple of years ago.

Second is capital adequacy. We've got ample capital, 11.6% CET1. Our LCR is at 147%. The industry is doing pretty well from a liquidity perspective, and we're certainly no exception there. So we think we're very much in a strong place. We've, in fact, got more capital than we did pre-COVID. And we also talked about our provisioning adequacy when we look at the body of work between Q2 and Q3, cumulative, we feel really, really good about our provisioning. And we look at the outlook on credit, I guess here I would say it feels better to us today than it did 3 months ago and 6 months ago, so we're positive on our outlook on credit. And we're delivering, lastly, on the expense management program that we've talked about, and we said that and I'll say now, that we expect that we'll be able to continue to deliver on that and do more going forward.

So when I put it all together, if you're looking for defense, we like our position on credit, capital adequacy, liquidity. If you're looking for offense, we think we've got more torque than perhaps others do on operating leverage. So we really like the package that we delivered in Q3 because we think it sets the frame really well for us as we move through the recovery.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

There's a lot there, and I definitely want to talk a lot about expenses. But first, I thought I'd start with the U.S. business. And I think it's fair to say the U.S. exposure has gone from something that investors couldn't get enough of to a source of concern in terms of margin pressure, in terms of credit, and then you add on COVID and social unrest and the coming U.S. election, and we can talk more about that. But I guess the opening question here for you is what do investors misunderstand about your U.S. platform and your U.S. strategy? And if you could kind of shed light on that, that would be a good place to start, I think.

Darryl White – Bank of Montreal – CEO

Yes. Sure. So good and fair question. I think what the investors might – some are absolutely along with us – but I think it's the case that some, to your question, might underestimate the scale, the strength and the reputation of our U.S. business. So when you just step back for a moment and you think of the banks that – in that regional to super regional space in the United States – that have strong reputation, strong brands have been competing for decades, it was 36 years ago almost this week that we completed the acquisition of Harris Bank, and as you know, we just continued to build from then. What we've established is a bank that stands on its own, frankly, in the United States as one of the best banks by reputation, by scale and by strength. And we talk about it today as something that is both mature and scalable, and that's what I like most about it. We've got a position in the marketplace that is both mature. We're a top 10 commercial lender in the United States. As you know, the market, Meny, is very fragmented. We've got hundreds of competitors, as is not the case in Canada, and yet here we are as a top 10 commercial bank in the United States. Inside of that commercial bank, you've got to think about how strong and how tight the relationships are. We believe we have the best clients because we choose each other. So just to help where people might not understand, back to your question, the preponderance of the relationships that we have in the U.S. where we are either the sole banker or the lead relationship in our commercial and business bank is well through 50%. And so here, you have whatever the opposite is of somebody who is going around and collecting syndication participations for loans that perhaps other people are not interested in. We're selecting the business that we like to do, and I think that might be underestimated as well.

So here, you've got a bank of brand and established presence in a marketplace that, in and of itself in the United States, is very prominent and very Mature, and within the entirety of BMO is about 1/3 of our bank. And I say 1/3, by the way, very deliberately. It's 1/3 of almost any metric now, whether it's 1/3 of our people, 1/3 of our loans, 1/3 of our revenue, and really, importantly, 1/3 of our net income comes from the U.S. I love the way that fits in our overall mix today.

And I guess the last point I'd make – and by the way, we could go on through the whole meeting on this, but as you know, we're also going to host an investor event to talk about our North American commercial business – so 68%, 69%, 70% of our U.S. bank comes from our commercial business, and we've got a really nice capital markets and wealth add-on to complement the other 30% of that U.S. business. That commercial business itself, as you'll hear more at the end of September, is completely integrated with our Canadian commercial bank, completely integrated. So I'm talking about the sales spine, the management, the credit underwriting standards, the actual credit officers, the technology platform. And we actually think it's the only fully integrated commercial platform on the continent. So we're on our way, we think, to building pretty close to the gold standard of commercial banking on the North American continent. And I do think that, that's a little bit misunderstood. And on the other hand, there are a lot more folks that are sort of coming along and starting to "get it," and we'll continue to help you educate people on that platform. It's one we're really, really, really proud of, though.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

I was going to ask you to provide a teaser for that Investor Day, but you beat me to it.

Darryl White – Bank of Montreal – CEO

All right. Well then, you have room for another question.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

I'll still be wearing a tie for that virtual event, too. No problem. I wanted to ask you about margins, specifically in the U.S., credit and margins. But first, let me start with margins. The margin pressure that you've seen in the U.S., significantly less than what we've seen across the peer group. And really, the question is how is that achieved and to what extent are the PPP loans a part of that, and then also, what's the outlook for margins in the U.S. in '21, is there a point where you will start to see some more significant margin pressure, especially as those PPP loans roll off?

Darryl White – Bank of Montreal – CEO

Yes. Okay. So U.S. margins, very good question. I think in the particular quarter, Meny, our margins in the U.S., our NIM was down 5 basis points. I think the expectation of us was that it would be down more. We saw our competitors in the U.S. down more. If you step back and unpack that and ask why, did the PPP loans have something to do with that, in fact, very little. Actually, at the margin, the PPP loans had a slight negative impact to margins. So it wasn't PPP driving the outperformance. Notwithstanding that, I will say here, we're very proud of the PPP performance our teams have had for our customers. We've got almost $5 billion of PPP loans on the books.

What's really going on there is kind of back to what I was talking about before in terms of how strong our teams are, frankly, in managing that business, both the treasury teams and the banking teams themselves in both personal and commercial. When you look at how we were able to offset the rate pressure that everybody felt on the spreads, the biggest driver to that was the fact that our deposits grew very significantly, both personal and commercial, but overweight commercial. So to give you a couple of data points, from Q1 to Q3, so if you kind of look through the bulge of the COVID cycle, we added a little over $3 billion of deposits on the personal side, and we added $15.5 billion on the commercial side. And that outpaced the market because, it goes back to what I was talking about earlier, when you've got the preponderance of your relationships or either sole or lead relationships, we're able to take those deposits and at the same time work hard on the pricing of those deposits and not give it away on price. So I think our teams did, frankly, an excellent job understanding both the balance sheet as well as their customer and putting that together. That's what really good, strong, mature and scalable banks do. And because we're able to bring the expertise of the global bank, we're able to do that, we think, a little bit better than some of our local and regional competitors where you're comparing that NIM performance.

As we go forward, I think you'll continue to see the industry have a little bit of NIM pressure in the United States. But at some point, as you know, that starts to roll off, as the rate changes work through. I think you asked me about '21. I think through the course of '21, we'll continue to see some pressure. As you know, it's one of the hardest things to forecast, particularly given such a fluid environment. But if you had me guess today, I'd say we might be in the 15 basis point range of further NIM compression. And if I had to guess how it stages over the course of the year, it's probably more back-end loaded than front-end loaded. So maybe a little less than people expect, and that will be because of the dynamics that I've talked about here, but a little further to go. And we're pretty proud of how we've performed through this so far.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

I just wanted to ask a follow-up on deposits, very remarkable deposit growth. What percentage of deposits are coming from outside of your footprint now and where do you think that can go? I know that's been one focus for the U.S. business there. So if you have some metrics on that in terms of where the deposits are coming from.

Darryl White – Bank of Montreal – CEO

I assume when you say footprint, you're talking about our core branch footprint relative to the rest of the marketplace. So an increasing share of our deposits is coming from outside of footprint. And the reason for that is because, remember, 1.5 years ago, we relaunched – we rebuilt and then relaunched our digital bank in the U.S. So we're now gathering – not able to, we're actually gathering – deposits in all 50 states in the U.S. So that share is increasing as we go forward, and those are all gathered digitally. So it's still not a huge share of the whole. If you compare it, for example, to our revenues where 50% of our total revenues in the U.S. come from outside of the Midwest, 50% of them come from in the Midwest. We're increasingly pushing our deposit gathering outside of core footprint through that digital offering. So it's not a big share of the whole, but it's a very large share of the net new growth, as we go forward. We would expect that to absolutely be the case as we move through next year and years to follow.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

Before I move to credit, just one last question specifically on the U.S., which is a big-picture question, and that's – what's your take in terms of the political risk in the U.S. right now, and how do you view the election and the outlook for taxation, are these all headwinds as you see them?

Darryl White – Bank of Montreal – CEO

It depends, right? When we look at the election on so many measures, polling and otherwise, your guess and all your listeners' will be as good as mine. But what I do know is that if we have a Republican administration, I think it's a pretty reasonable guess to say we're going to see more of the same as we go forward. If we see a Democratic administration, I then think you have to look through what happens in Congress. So we might have a democratic White House. Pretty hard to see, in my view, how the Democrats would lose the house, but then the real question becomes what happens in the Senate, and it's a jump ball. I think it's 50-50 as to whether in a Democratic White House, they will also get the Senate. If they do get the Senate, they've got to get through that 51, 52 seat threshold to be able to get the votes to pass legislation easily. They could only get 1 or 2 done in a reconciliation process otherwise. I think it's been interesting that we haven't seen a detailed tax platform from the Biden administration so far. I won't go so far as to say that that's particularly telling, although it is a fact that we haven't seen that yet. So my roll up to the whole thing is pretty simple, Meny, which is a Republican administration, more of the same; Democratic administration, not sure. And I'm not so quick to judge that instantly, if you have a democratic administration, you're going to have a profound change because a lot would have to happen, particularly in the Senate itself, and then you'd have to get laws passed, and so we'll see.

But in any event, even if we went down that route, and all of those doors opened up for the Democrats, I'll tell you I'm not particularly worried about it because we've been around – we did our first commercial transaction in the United States in 1818, and we've been building our business pretty successfully ever since. And we've seen lots of Democratic administrations, and we've seen lots of Republican administrations. And as I look through it and look out to the horizon, there's just no better market in the world to compete in. And anybody who has bet over the long run on the U.S. market, the commercial market, the consumer market, the capital markets, has turned out to be a winner through administrations, and that will be our strategy, regardless of what happens in November.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

I wanted to talk about credit, because how can we have a conversation in 2020 without talking about credit? So it's really about – when I speak to investors, there's definitely a group that are somewhat skeptical about what the credit outlook for BMO looks like. You talked about Q3 and increasing your allowances and your comfort level in terms of your reserving. I think it has to do with the fact that if you look, I mean, historically, especially in more recent history, BMO's write-off performance has been at the peer group low, and it's been pretty remarkable. But I think when investors look at that and extrapolate to the future, they see a lot of commercial lending, especially in the U.S., and they get nervous that kind of lending will lead to losses in this kind of environment. So the question is where does that viewpoint have it wrong, from your perspective?

Darryl White – Bank of Montreal – CEO

It's a good question, and thank you for it. And we'll talk more about that in particular, you talked earlier about the teaser for our event at the end of September, so we'll unpack this in quite a bit of detail there. I'll have Dave Casper, who runs our commercial business from a North American perspective, including the U.S., Pat Cronin will be there, and as well they'll have their commercial teams and their risk teams, and we'll get right to the heart of your question. But I'll tell you from my perspective why we're pretty comfortable here. You talked about recent credit performance being lower losses as a share of our loans outstanding to peers. That isn't recent. I guess the first point I would make is that's been the case, if you look at our investor presentation, for the better part of 40 years. And so to conclude that it would be different this time, you would actually have to conclude that something is profoundly different this time with the way we either underwrite or the way we select clients or the way we've built our portfolio. And so the first point I would make is that there isn't anything different. We've been doing this pretty well for decades, and we think we continue to do it well.

The second point I would make is that when you look at the formations, we talked a little bit about this on our call, what you actually see is a fair bit of concentration. So this doesn't – as we've got the benefit now, Meny, of looking back 6 months – this doesn't feel like a recession where the wave knocks everybody out equally and has the level of stress equally across sectors or geographies. We're starting to see that there's a lot more concentration in the places that you know well: oil and gas, part of that COVID related, part of it not; the concentration around the high-density mobility industries on leisure and travel and hotels and tourism, naturally; and a little bit in the manufacturing sectors. But when you step back from those concentrated areas and you look at the rest of the economy, I would say that the credit picture is evolving, frankly, a lot better than we would have thought 3 months ago, 6 months ago. And we know we're not out of the woods yet, and things could change as we go through the fall and the winter here today. But as we look at it today, we feel pretty good about that credit picture.

So 2 points. One, we've been good at this for a really long time. This isn't a new skill for us to outperform on credit. And two, when we look at the composition of our book against the current dynamics on formations, we feel pretty good. Notwithstanding all that, we added, I think, quite prudently over the course of Q2, Q3, to the performing provision. So when I put all that together, I think we're in a really good place. And as I said, with respect to commercial, particularly, which is I know where you get a lot of the questions, happy to go into it further today, if you want, and we're certainly happy to go into it in a lot of detail at the end of September.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

That's great. I wanted to move on to expenses. And I think, on a related note, also technology, and we'll see where we are in terms of time. But first off, in terms of expenses, and I think when you were giving your opening remarks, you talked about having an operating leverage advantage. So I just wanted to dig into that more and better understand what you meant by that. Are you referring to the restructuring that you're doing and the benefits that you'll see from that over the short run, or is it much more structural advantage that you see?

Darryl White – Bank of Montreal – CEO

I think it's both. And if your question is why do I feel confident in the claim of an operating leverage advantage, well, in part, it's because the proof is there real time. When we look at it over the last 12 months, relative to the peers that you cover, I think we're #1 on operating leverage, we're #1 on efficiency improvement with more opportunity there than our peers, to be fair. I think we're #2 on PPPT growth. And so the proof is absolutely there in terms of operating momentum, which I think really does matter as you just think about what recovery looks like. It hasn't been the focus, I know, of investors over the last couple of quarters, but that momentum really does matter as you look to the torque on the other side when the sector has a little bit of more opportunity to go on offense. So there is that dynamic.

In the quarter in question, Meny, our expenses were down 2% year-over-year, which was better, on average, and I think – than all of our – than our peers. And that was partly assisted, as everybody was, by COVID. COVID is an interesting thing. You have some things that go down. This conference is costing you guys a fraction of what it would have cost you last year. You've got all sorts of travel and entertainment where the doors are shut. But at the same time, as I think some of my peers have noted, you've got to make investments, and you've got investments in the branch, and you got to make sure that you're able to provide for all the health and safety measures. Net-net, there is a little bit of a COVID advantage in our current expense performance, but it doesn't account for all of it. The majority of our expense performance is a result of decisions that were taken 12 and 18 months ago.

And then when I roll it forward, I guess I would say to you, I feel equally confident because when we announced in the fourth quarter of last year that we would work hard at rightsizing our workforce – and that was because, by the way, we had a point of view that revenues were going to be tougher to get at in terms of growth going forward. We didn't see COVID coming, but we did see rates and the shape of the curve, and we started to see that the spending patterns might change a little bit. And we put in place, as you know, a pretty disciplined program at the time. We were about almost exactly 50% of the way through the execution of that program in February when COVID hit, and we decided at the time that we would pause because, frankly, for stability reasons, everybody was trying to figure out where you needed people and how you needed people during COVID and also just because it was the right thing to do from a humanitarian perspective. But we also recognize that there's another 50% to go, and we've got that accountability to shareholders. And so we, a couple of weeks ago, in fact, started to resume that program. So I'd expect that you'll see the benefit of the resumption of the other 50% through the course of the back end of this year and dribbling into the beginning of next year. So the benefit of that is still to come, as well as, frankly, all of the other initiatives that we're working on and the benefits of all the technology. You talked about technology and the $2 billion-plus of technology investments that we made for several years running. I think that you're only starting to see the crest of the wave on the digitization of work processes, of working out low-value processes, low-value work to the benefit, not only of the employee experience, but of the customer experience.

The prime example of that, that I'd like to talk about is the fact that we were able to reduce the lead time and the process time of small business lending from 30 days to 30 minutes. There's lots of examples of that around the place where we're working on improving our efficiency, not just through that restructuring program that you asked about and I referred to, but other things that we're doing. That 50-state deposit gathering capability digitally in the U.S. is a pretty strong advantage relative to those that don't have it, which is the case with many of our U.S. competitors. So those are just a couple of examples that would say you, that should give you comfort that I'm confident that we'll be able to keep it up because I said, not only do we think we've done well on expenses, but there's more to do. Those are examples of why there's more to do.

What does it all roll up to? I think by the end of this year we'll likely show something in the range of flat total year expense performance, maybe with some opportunity to be slightly down in constant currency, but think flat for the year. And then what does that mean for next year when I put all these things together that I'm talking about? We're working on the possibility of staying flat for next year as well, which is really hard to do because you make a lot of investments in the meantime. We're making investments in our high ROE businesses. We're putting new investments in place with people in our banking businesses and our fee business and our wealth business. We've got some expenses that we committed to a long time ago that just are what they are from a real estate perspective or pension expenses where you have escalators. So to be able to come out and say, despite all that, where we think we really want to continue to make investments, we'll be able to get the net to somewhere around the flat water line. I'm quite proud of that work. It's really hard work. We think we've come a long way, and we've got more to do.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

That flat sounds pretty remarkable. We're getting close to the end, but I thought I would talk about expenses and technology together in a broader question that I'm trying to ask all your peers. And that's really, in this kind of environment that's so uncertain, how do you make investment decisions a go/no-go decision, how do you do that and how do you balance – you talked about it – how do you make sure you're not underinvesting in your business when you're making these decisions, what are the kind of metrics and processes that you have in place to help you make those kinds of choices?

Darryl White – Bank of Montreal – CEO

Some of them are the same, Meny, as they've always been. And then some of them are just, I'd say, a little bit more dialed in and a little bit more acute. So think about it this way. We always consider investments, strategy first, strategy first, strategy first. So is it on strategy? Does it further an existing strategy? Does it get us deeper into a customer relationship? Does it allow us to take share, which is with the concentration of the industry in Canada, it's hard for all of us. But in the U.S., it's not that hard because we've got competitors that we think we're significantly advantaged relative to. So we look at strategy first. We consider our ability to invest, to serve the customer and to take share as we do it.

And then in an environment like this, I think, where you get a little bit sharper and a little bit more dialed in is on the ROE. Because when you consider an environment going forward, where revenues will be harder to grow because we've got the yield curve where it is, we've got rates where it is, and for now, consumers and commercial borrowers seem to be in a bit of a holding pattern on spending. By the way, that will release, I just don't know when, but it will release when people start to see the light at the end of the tunnel. But in the meantime, if you've got flatter volumes and you've got rates where they are, you'll have flatter revenues. And therefore, you have to have both an expense response, which is the one I talked about earlier, which we feel really good about. And then you start to get really sharper on looking where the ROE opportunities are and really making your choices to deploy resources into higher ROE opportunities and perhaps at the expense of those that have lower ROE opportunities relative to the choice to say everybody gets a little bit of everything. So I think you can look for us to make those choices crisply going forward as well.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

And then one final question for you, just in terms of this whole technology topic, especially when it comes to digitization and specifically in the P&C bank, it seems like Canadian banks are letting consumers lead. And the question is at what point does the bank need to start to force change, or is a gradual response just the right business decision? And I'm thinking about in terms of more aggressive branch cuts, in particular, or somehow pushing customers to do more than maybe what they're comfortable with right now online rather than just continuing to move in step with where the clients are going. Is there any justification for being more aggressive in that area or in any area, specifically?

Darryl White – Bank of Montreal – CEO

I guess, I know you're paraphrasing the questions that you get, so it's probably not your language. But the point I often with people take exception to is the idea of pushing customers. It's really an interesting thing that we've seen through this COVID cycle where, you've watched it for the last 4 or 5 years, the fintech threat from the monoline fintech – who's got a really good product but has a really big challenge in terms of access to capital and cost of capital and, frankly, customers – is really a diminished challenge for us today relative to what it was a while ago, because we've got a low cost of capital, we've got lots of customers, and we're able to develop some of those products ourselves, or we were able to develop it with some of our fintech partners. I think that ecosystem is really good, and it plays to our advantage.

And on the customer behavior that you're getting to, I think what we've actually seen through this COVID cycle has been a really interesting education. When we went through the shutdown period, but bank branches were open, you talked about the branch footprint in the early phases of COVID, you saw exactly what you'd expect. You saw a lot less traffic going through the branches. And then what's really interesting, though, is through the reopening phase where a lot of that traffic stayed home, and perhaps the people who, prior to that, didn't want to go through the friction of learning how to do things digitally, either on their phone or on their PCs, they figured it out. And now what we're seeing is they're coming back into the branches. It's quite interesting to me that the consumer behavior of choice is as profound as it is. You might have thought that they would all stay home forever, but that's not the case. In fact, we're going to extend our opening hours once again here going forward, and that's because it's consumer driven. It's consumer demand. So we actually don't take the view that we should force the behavior of consumers into any one channel. We take the view that we should meet the consumer where they want to be met, and we've got the ability to do that omnichannel. We're leading in digital sales at the same time while we have the smallest branch footprint among our competitors. So we don't really feel the pressure to adjust the network just yet. We'll see, Meny, in 6 months, 12 months from now with the benefit of the full data set of consumer behavior from COVID, because we're probably only 1/3 of the way through it, but at this point, we're pretty happy with where we are, and we don't see any need to adjust.

Meny Grauman – Scotiabank Global Banking and Markets Research Division – MD of Financial Services Equity Research & Analyst

With that, Darryl, I want to thank you very much for being with me virtually. And I guess we'll see you at your Investor Day, which is coming up, put another plug-in for that, and thank you very much.

Darryl White – Bank of Montreal – CEO

Thanks, Meny. Good luck today.