BMO Financial Group

Q3 2009 CONFERENCE CALL

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Viki Lazaris *- BMO Financial Group - SVP IR*

Thank you. Good afternoon, everyone, and thanks for joining us today. Presenting today are Bill Downe, BMO's Chief Executive Officer; Russ Robertson, Chief Financial Officer; and Tom Flynn, our Chief Risk Officer.

The following members of the management team are also here this afternoon. Tom Milroy from BMO Capital Markets; Gilles Ouellette, head of Private Client Group; Frank Techar, head of P&C Canada; Ellen Costello from P&C U.S.; and Barry Gilmour, head of Technology and Operations. After the presentation, the management team will be available to answer questions from prequalified analysts. To give everyone an opportunity to participate, we ask that you please ask one or two questions then requeue.

At this time I'd 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; and you can find additional information about such material factors and assumptions and the material factors that could cause actual results to so 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.

As you've seen, BMO reported very good third quarter financial results. These results underline the continuing success of the customer focus that we are demonstrating across all our businesses. They also point to the substantial long-term earnings capacity of the Bank. Russ is going to review the financial results in more depth; but let me highlight some of the big picture numbers.

Net income for the third quarter of fiscal 2009 was $557 million with an ROE of 12.1%. Strong momentum in our core businesses is highlighted by our pre-provision pretax earnings of $1.1 billion. This compares with $885 million in Q2 after adjusting for the severance costs we took last quarter, and up 15% from a year ago.

We are successfully executing on our strategy of providing customers with a value proposition that helps them make sense of their banking and investing.

Our financial results underline the rebalancing of our businesses through a systematic, multiyear effort aimed at strengthening our brand, customer loyalty, competitiveness, and core business performance. I'm pleased with the performance of our businesses and we are confident in our momentum.

Looking at the broader economies, there is a normalization under way. We are identifying growth opportunities and we're well positioned going into 2010.

With respect to the provision for credit losses, we've taken a methodical approach to valuing our loan book and we are comfortable with where we stand. We expect PCLs to remain elevated into 2010; however we're confident that the strength of our core business earnings will absorb our credit losses through this cycle.

There has been some attention on US commercial real estate in the investment community. For context, BMO's exposure is small at around 2.5% of our total loan portfolio. We still benefit from the knowledge about this sector that we developed in the early '90s and our lending practices reflect that experience. We are monitoring this portfolio carefully, and we continue to make adjustments to the portfolio on a risk-return basis.

Moving to slide 4, you can see that we continue to strengthen our balance sheet, highlighting our capacity for future growth. At quarter end, Tier 1 capital was 11.7% and our tangible common equity to risk-weighted asset ratio was 8.7%.

Let's turn now to the results of our four operating groups. Let me remind you that we book expected loss in the businesses each quarter, and the timing differences between expected losses and actual losses are recorded in corporate services; and Tom is going to provide some color on actual losses a little later in the call.

P&C Canada posted excellent results for the fourth quarter in a row, with solid momentum continuing across all business segments. Our focus on improving our customers' experience, including the brand promise of bringing clarity to their financial decisions, is paying off. The Group earned $356 million in Q3, which was 13% ahead of prior year and 6% higher than the second quarter as a result of strong revenue growth of 8% year-over-year and operating leverage of 2.4%.

In personal banking we experienced a 15% year-over-year increase in loans. Deposits increased over 15%, with our market share increasing 32 basis points year-over-year. In Commercial Banking compared to a year ago, revenue growth was 17% with market share up 21 basis points. Loan growth was flat as expected, while deposits increased 10%.

P&C Canada was recognized this week when the global market research firm Synovate announced the winners of its 2009 Best Banking awards, which are based on its customer service index. BMO Bank of Montreal showed the most year-over-year improvement by winning three awards in 2009, including one for branch service excellence.

Our P&C U.S. business earned $29 million on a cash basis this quarter. Results benefited from improved loan spreads, deposit retention, and gains on the sale of mortgages. However, nonperforming loans and the cost of managing these loans have increased. We are focused on containing costs and on adding new customers. Non-interest expenses were up less than 1% year-over-year, while deposits increased 10%.

Harris's “We're Here to Help” media campaign is working and our retail net promoter score remains strong and consistent at a time when the scores of a number of our competitors have been deteriorating. We've also just launched the new Harris advertising that highlights our JD Power number one position in Midwest retail banking [1].

Private Client Group earned $120 million in the quarter, increasing $42 million or 54% sequentially. This is the first full quarter that insurance is included in PCG, reflecting our confidence that insurance will play an important part in the expansion of our wealth management businesses for BMO.

Higher revenues were achieved across all lines of business amid better equity markets. Assets under management and administration improved by $6 billion or 6.5% in source currency from the second quarter due to improved capital markets and new client assets.

This quarter we announced the launch of four new exchange traded funds to further expand the investment product offerings to our customers. And BMO is the only major Canadian financial institution to offer a family of these low-cost, easy-to-understand investment products. While the funds have been listed since June, we are looking forward to a broad market launch early in the fall.

BMO Capital Markets had another quarter of strong financial performance with earnings of $343 million. There we are benefiting from revenue opportunities across a number of our trading businesses that are arising from client flows, a favorable interest rate environment, and narrowing credit spreads. We hope to continue to benefit in this way into 2010 if these market conditions continue.

In the longer run, we have confidence that our client-centered strategy will continue to generate high quality earnings with an attractive return on equity for BMO.

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[1] Harris is ranked “Highest in Customer Satisfaction with Retail banking in the Midwest Region in a Tie”. Visit jdpower.com for more information

I want to highlight one area of expansion that's going to benefit all of our business groups. We participated in the Canadian China Trade Mission which took place a couple of weeks ago. While there, Finance Minister Flaherty presided over the official opening of BMO's expanded offices in Beijing. China remains a key differentiator for us and a positive option for future growth.

The country continues to show compelling market dynamics and a prolonged trend of wealth accumulation and BMO has a strong position there. With well-established teams in Beijing, Shanghai, Guangzhou, Hong Kong, and Taipei, we know we have an enviable long-term platform for growth for all of our operating groups.

Before I turn the discussion over to Russ, I'd like to refer to our economic outlook which is reflecting the normalization process I referred to earlier. Fiscal and monetary stimulus in North America and abroad is kicking in, signaling that an economic recovery has begun. The Canadian economy is strengthening, led by consumer and government spending and a rebounding housing market.

While there are positive indicators in the U.S., its economy may not return to healthy growth until 2011 as consumers pay down debt and rebuild savings. The short term economic outlook is more positive in Canada, where personal income growth is stronger and job losses are more moderate. At this stage Canadian consumers and governments are carrying less debt relative to their US counterparts.

We are expecting a modest rise in Canadian GDP in Q3 after three quarterly contractions; and we have revised our 2010 forecast to + 2.2%, with further upside potential.

The US is expected to emerge from its longest and deepest recession in seven decades, with growth likely in the third quarter, driven partly by government incentive programs. Central banks in both Canada and the US are expected to keep interest rates low until next summer to foster an enduring recovery.

Before I ask Russ to speak to the financial results I'd like to acknowledge the retirement of Karen Maidment this month. Karen has been on medical leave since October of 2007. We are happy to say that she has recovered from her illness and we wish her all the best. In particular I want to thank Karen for her contribution to the Bank during her tenure as Chief Financial Officer.

At the same time I would also like to acknowledge and thank Russ for his continuing leadership as CFO. And, Russ, the floor is now yours.

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

Thanks, Bill. I'm very happy to be here and good afternoon. As some of my comments may be forward-looking, please note the caution regarding forward-looking statements on slide 1.

Our core businesses continue to deliver good results with record revenues in the quarter and bottom-line growth in this slower economy. On slide 3, you can see the reported third-quarter earnings were $557 million or $0.97 per share compared to $0.98 last year. On a cash basis, earnings were $0.98 per share and our Tier 1 capital ratio remains strong at 11.71%. Adjusted cash EPS was $1.05 after excluding an increase in the general allowance of $0.07 per share.

Credit costs remain elevated as expected, with specific provisions for credit losses of $357 million in the quarter.

Effective in this quarter, to better align our Wealth Management strategy, all of BMO's insurance businesses now operate within the Private Client Group. We've also moved the term investments business to P&C Canada, achieving better alignment with P&C's retail product strategy. All prior periods have been restated for these changes.

Turning to slide 4, record revenue at $3 billion was up 12% quarter over quarter. The increase was largely driven by continued strong performance in P&C Canada and BMO Capital Markets.

Corporate services revenue also improved as expected, as the negative carry on funding continues to moderate, as evidenced by higher net interest income in the quarter, which was partially offset by lower non interest revenue.

Year-over-year revenues increased 8% with strong growth in BMO Capital Markets, reflecting significantly higher trading revenues and higher corporate banking revenues. P&C Canada also contributed to the increase, with volume growth across most products and higher net interest margin.

Revenue was lower in the Private Client Group and in corporate services due to the market environment. However, we are encouraged with the quarter-over-quarter improvement in our wealth businesses.

The stronger US dollar increased revenue by $75 million year-over-year. In the quarter credit valuation adjustments were favorable at $61 million, but were more than offset by $74 million of mark to market losses on credit default swaps. Both of these were as a result of tightening credit spreads.

There were no material charges related to our credit protection vehicle or our other off-balance sheet entities.

Net interest income was $1.5 billion in Q3, up $184 million or 14% year-over-year, driven mainly by improved spreads in our P&C Groups, combined with higher spreads in corporate lending and higher trading revenues in Capital Markets. Quarter-over-quarter, net interest income increased $131 million or 10% mainly due to improved margins in P&C Canada and corporate services as well as three additional days in the current quarter.

Looking more specifically at margins, total Bank margin was up 16 basis points year-over-year driven by P&C Canada and BMO Capital Markets, and 19 basis points quarter-over-quarter driven primarily by corporate services and P&C Canada.

In P&C Canada, net interest margin increased over both comparative quarters. Year-over-year margins were up 33 basis points. Approximately half was due to deposit growth outpacing loan growth; about a third from the impact of securitizing low-margin mortgages; and the remainder from favorable prime rates relative to BA rates as well as actions to mitigate the impact of rising long-term funding costs. The quarter-over-quarter increase of 3 basis points can be attributed to higher mortgage refinancing fees.

In P&C U.S., margins were up 2 basis points year-over-year and 8 basis points quarter-over-quarter. Higher lending spreads on both consumer and commercial loans contributed towards the quarter-over-quarter increase.

In Capital Markets, margins increased 32 basis points year-over-year due to higher spreads in corporate lending and increased trading. Quarter-over-quarter, margins declined by 7 basis points reflecting lower corporate lending due to reductions in the loan portfolio. Quarter-over-quarter margins in corporate improved as the negative carry on certain asset liability management interest rate positions moderated as expected.

Turning to slide 6, year-over-year expenses were up $91 million or 5.1%. The strong US dollar accounted for just under half of this increase, with the remaining increase due to the impact of acquired businesses as well as higher employee benefit costs and performance-based compensation, which is in line with improved revenues. Expenses decreased $15 million or just under 1% quarter-over-quarter despite absorbing higher performance-based compensation costs, increased FDIC premiums, and acquisition / integration costs.

We continue to focus on expense management and improving productivity across the Bank, and we are pleased with the progress we have made on controlling core expenses.

On slide 8 you will see that our risk-weighted assets were $172 billion at the end of Q3, down $13 billion over Q2 due to the impact of a weaker US dollar and lower risk-weighted assets in the corporate loan and trading portfolios.

Our Tier 1 capital ratio was strong at 11.71% in the quarter. We consciously decided to increase our capital ratios during the market turmoil to be in a position of strength and be able to continue to make credit available. We've issued common and preferred shares and innovative Tier 1 capital since October 31. However, we have experienced lower risk migration under Basel II than we had expected, and loan growth was also lower, which has elevated the ratios. Looking forward we expect the ratios to decline through fiscal 2010 as demand for lending increases during the economic recovery. The tangible common equity to risk-weighted assets ratio also increased to 8.7%, which remains top tier.

Turning to slide 9, BMO has long-term wholesale funding maturities of $4.8 billion remaining in fiscal 2009 and $10.6 billion for fiscal 2010. These maturities have been largely pre-funded through growth in customer deposits and by participating in the government's insured mortgage purchase program originally scheduled to expire in March 2009. This additional funding has been invested in short-term high-quality liquid assets.

In conclusion, our results this quarter reflect high quality earnings delivered by our businesses with strong capital and liquidity levels and good cost management. With that, I'll turn things over to Tom.

Tom Flynn - BMO Financial Group - Chief Risk Officer

Thanks, Russ, and good afternoon. Before I begin, I draw your attention to the caution regarding forward-looking statements. I'll start with some summary comments on the risk front for the quarter.

First, specific provisions for loan losses were similar to last quarter at $357 million. Provisions are elevated and we expect this to continue, given weakness in the economy and high unemployment levels. We are continuing to see migration in the portfolios, but the pace of migration has moderated in a number of areas.

Second, with the improvement in capital market conditions and actions we've taken to reduce some of our positions, there were no capital market charges of note in the quarter.

Lastly, we continue to be comfortable with our risk profile. Our credit risk management is sound. We've taken steps over the last two years to reduce risk in certain areas, and the parts of our portfolio that are impacted more by the environment are performing reasonably and are not outsized relative to the overall balance sheet.

I'll start now with slide 3, where we provide a breakdown of our loan portfolio. As shown, 71% of our loans are in Canada and 23% are in the US. Within the Canadian portfolio, 62% of assets are consumer loans. Of this total, 85% is secured and 88% is secured excluding credit cards. Our US portfolio mix is 42% consumer with commercial and Capital Market loans making up the larger portion.

Slide 4 provides details on our US operations. The US consumer portfolios are relatively evenly spread across first mortgages, home equity, and auto loans. Provisions within these segments continue to be elevated given the environment but performance is better than peers.

The slide also provides information on our US commercial real estate portfolio. Our exposures in this area are not outsized, at US$4 billion or 2.5% of total loans and about 10% of US loans. Within this sector, developer loans are US$1.2 billion, down over 20% year-to-date. As we had said before the performance of the developer segment has been particularly negatively impacted by the environment.

Our underwriting practices in the investor-owned mortgage book were prudent. The portfolio is predominantly in our midwest footprint, and approximately 80% was underwritten to a prudent loan-to-value ratio of 75% or better. The portfolio is also well diversified by subsector and on a single name basis.

Turning to slide 5, the chart on the left shows the segmentation of impaired loan formations during the quarter. Formations were $549 million, down from each of the last two quarters. The segmentation shows that the majority of formations were from the US, consistent with the past few quarters, although the percentage coming from the US has decreased.

Formations and impaired loans are well diversified by sector. Commercial real estate and mortgages and manufacturing represent the largest component of formations and impaired balances. On the right side of the page you see that gross impaired loan balances totaled $2.9 billion, in line with the level last quarter.

Slide 6 details our provision for credit loss by business group. The consolidated specific provision was $357 million, lower than Q2 which was $372 million. As a reminder, the provision last quarter included $41 million for a change to our approach for dealing with part of the Canadian consumer portfolio. Excluding the impact of this $41 million, specific provisions were up modestly from last quarter.

The P&C Canada consumer and commercial portfolio continues to perform well given the environment. Provisions are up in the quarter in the consumer segment, largely due to higher credit card losses. And the commercial segment is up from a very low level last quarter.

P&C U.S. provisions remain essentially unchanged from last quarter. Provisions in this business remain elevated given the state of the US housing market and overall economy. The Capital Market provisions were down slightly from last quarter. Lastly, there was a $60 million increase in the general allowance which reflects the continuing weakness in the economy.

Turning to slide 7 you can see a segmentation of the specific provision by geography and sector. The Canadian provision was $144 million. The consumer segment continues to be the largest component of that. The manufacturing component is reasonably well diversified by subsector. The US provision is segmented in the pie chart on the lower right and was $193 million, down $52 million from Q2. The largest segments of US provisions were consumer loans and commercial real estate and mortgages, approximately 55% of which was developer related.

Slide 8 shows information related to our consumer credit performance relative to peers. The information on the slide highlights that our credit performance in both Canada and the US compares favorably to peers across a range of product lines. This performance reflects a disciplined approach to the business and is consistent with our long-term outperformance on credit risk.

Slide 9 summarizes the information that we have provided the last few quarters on structured credit and investment vehicles. There were no significant credit-related developments in the underlying portfolios during the quarter, and tighter credit spreads had a positive impact on asset values.

While our analysis continues to support the conclusion that any realized credit losses will be well below the amount of outstanding Apex notes, we have taken advantage of better markets to hedge much of our Apex exposure. We have hedged the $815 million in notes that we hold; and as a result now have no further exposure to Apex notes.

We have also hedged the first half of our senior funding facility. These hedges, together with the credit quality of the underlying portfolios and the first-loss protection in the structure make the risk of realized loss very low.

With respect to the SIVs we continue to think that the size of the subordinate capital notes will protect our senior funding from loss.

That concludes my presentation, and we can now move to the Q&A.

QUESTION AND ANSWER

Operator

Mario Mendonca, Genuity Capital Markets.

Mario Mendonca *- Genuity Capital Markets - Analyst*

Good afternoon. A question first on the explanation, I believe it was Russ, you're providing us the explanation on why there was a 33 basis point increase in the margin year-over-year. You referred to -- I'm not sure if it was in your comments, but in the text -- it was the securitization of lower-margin mortgages. Am I correct, first of all, that was a portion of the increase?

Russ Robertson *- BMO Financial Group - CFO*

Yes.

Mario Mendonca *- Genuity Capital Markets - Analyst*

Now, what caught me a little bit off guard is most of the banks -- and maybe BMO is a little different here. But most of the banks, really in retail they really account for the securitization activity on a managed basis. So corporate really picks up the difference. Is BMO different in that respect?

Russ Robertson *- BMO Financial Group - CFO*

No.

Mario Mendonca *- Genuity Capital Markets - Analyst*

No. So why is it then that securitization activity would have affected the retail margin?

Russ Robertson *- BMO Financial Group - CFO*

Well, we make whole on the revenue side, but the balances are removed from the loan books sitting in retail.

Mario Mendonca *- Genuity Capital Markets - Analyst*

So retail is not then on a managed basis?

Russ Robertson *- BMO Financial Group - CFO*

I misinterpreted managed, but we do make whole on the revenue. But we don't reclassify the balances back to the balance sheet of retail, which is I guess your view of what managed would mean.

Mario Mendonca *- Genuity Capital Markets - Analyst*

I guess what I'm saying -- so the denominator of the calculation, you have removed the loans. So the denominator of the calculation goes down, but you've made the revenue whole.

Russ Robertson *- BMO Financial Group - CFO*

Yes, Frank would like to jump in here.

Mario Mendonca ***- Genuity Capital Markets - Analyst***

Okay, please.

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

Yes, Mario, the business is kept whole, but we reflect the revenue in NIR not in NII. So we do eliminate the balances from the calculation of them NIM, but there is no securitization revenue or keep-whole revenue that is reflected in the NII as well.

Mario Mendonca ***- Genuity Capital Markets - Analyst***

Okay, so --

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

So for purposes of NIM calculation, securitization has no impact on net interest margin in P&C Canada.

Mario Mendonca ***- Genuity Capital Markets - Analyst***

It has no impact?

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

Well, it has no revenue impact. The denominator is affected by the elimination of the balances that are secured.

Mario Mendonca ***- Genuity Capital Markets - Analyst***

Okay. Sorry Frank, you just said that the NIM is unaffected by it. But in your text you're saying that it was increased because of it. So I'm really confused now.

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

P&C Canada's NIM is impacted as the balances are eliminated from the denominator; but there is no NII in the keep-whole because it is reflected in our NIR not in the NII.

Mario Mendonca ***- Genuity Capital Markets - Analyst***

I think I understand that. Thank you. And then is that different from your peers?

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

I Don't know.

Mario Mendonca *- Genuity Capital Markets - Analyst*

Okay, I'll follow up on my own then. Another question. It seems like gross impaired loans in Europe were up a little bit. Maybe this is a small book of business, but could you help size it for us?

Tom Flynn - BMO Financial Group - Chief Risk Officer

Yes, it's Tom Flynn. I'll go ahead. I think we provide segmentation in our supp pack of the exposure. It's a quite small book of business. From memory it's on the order of $1 billion. And we did have a credit that became impaired in the quarter.

Mario Mendonca *- Genuity Capital Markets - Analyst*

Maybe just one final question for Tom Flynn. It sounds like you have hedged that exposure, the $815 million related to Apex. But if I am not mistaken, there is a $392 million provision against that already. Is the provision still required now that you have hedged the exposure?

Tom Flynn - BMO Financial Group - Chief Risk Officer

I think the way to think about it, Mario, is that we have hedged the notes; and as we've talked about we've also hedged the first $500 million of our senior funding facility. And in effect, the hedge crystallized the marks that we have taken to date on the notes.

So there won't be a material or significant change in the carrying value of the notes as a result of the hedge, and there won't be a recovery or any further loss on the provision.

Mario Mendonca *- Genuity Capital Markets - Analyst*

Thank you.

Operator

Ian de Verteuil, BMO Capital Markets.

Ian de Verteuil *- BMO Capital Markets - Analyst*

It's a question regarding trading revenues and mark-to-market losses on a variety of things. It seemed as if -- I mean, the trading revenues look excellent. It looked to be all in interest rates. I was hoping maybe Tom Milroy could provide some color on that.

Is that really the yield curve, and is that a business where that is going to moderate if we get any sort of flattening to the curve?

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

Yes, Ian, the answer is that the trading revenues were obviously very strong in the interest rate sensitive areas, but they were also good across a number of the other businesses including FX, equity, and a few others.

But the answer to your question is yes; if the interest rate environment changes then obviously we will not see revenues driven in that area to the same extent that we have.

However, as we've seen in past history, we would expect that certain businesses, the performance suffers as a change of the rate environment, we will be able to pick up the revenue streams from some of our other businesses that aren't benefiting the same way today.

Ian de Verteuil ***- BMO Capital Markets - Analyst***

Tom, it didn't look as if foreign exchange was that good. It looked to be lower. Am I missing something? I'm looking at page 12.

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

It's been down off the record foreign exchange trading revenue we had in the first quarter, Ian. It's been down and down. But it's still up from where we have historically run the business.

So on a relative basis, that's another area that continues to be pretty strong on a historical basis.

Ian de Verteuil ***- BMO Capital Markets - Analyst***

In the corporate segment, there was a comment of mark-to-market losses on hedging activity. Does that flow through the trading revenue line or does that show up somewhere else?

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

It's Russ. It does flow through in the other line in trading. And it swung about $70 million from a positive to around $50 million negative in the quarter. That relates to corporate hedging initiatives, cross currency swaps, etc.

Ian de Verteuil ***- BMO Capital Markets - Analyst***

Is that the hedges on the loan book, is that credit default swaps to protect you from --?

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

I'll turn that back to Tom. That's a different line item.

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

Yes, under the credit default swaps on the loan book we carry in our part of the business, Ian. And as was mentioned before, this quarter the offset to the CVA was mark-to-market losses on the CDS. As spreads came in, you gain in one area and you lose in the other.

And that's, I would say to you, that's something that's happened in our business on an ongoing basis.

Ian de Verteuil *- BMO Capital Markets - Analyst*

So that comes through on the other line on trading revenues, Tom?

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

I beg your pardon?

Ian de Verteuil *- BMO Capital Markets - Analyst*

That comes through the other line in trading revenues? They're the net of those two? The CVA net of the mark-to-market losses on hedging?

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

No, that comes through on the interest rate line.

Ian de Verteuil *- BMO Capital Markets - Analyst*

On the interest rate line? Okay, thank you.

Operator

Steve Theriault, Merrill Lynch.

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

Thank you. A couple of questions for Tom. On page 29 of the supp pack it looks like Canadian consumer delinquencies have largely stabilized this quarter. Tom, how comfortable, if at all, do you think we should be that these metrics won't move meaningfully higher over the next few quarters?

And a second one if I might. The reductions in impaired loans this quarter, a pretty big number at $233 million. Did this represent more predominantly loan sales or recoveries? Can you give us a bit of color and insight on that figure as well? Thanks.

Tom Flynn - BMO Financial Group - Chief Risk Officer

Sure. First on page 29 of the supp pack where we've got the consumer delinquency numbers, we referred both in our press release and in the comments here to moderating migration in the portfolios; and you see that, the delinquency numbers on page 29.

In Canada the delinquency numbers are flat quarter over quarter at 62 basis points. We aren't calling a bottom here; what we are saying is that we are seeing moderation in the negative trend that we've seen.

So I think it is possible that as unemployment more likely than not trends up a bit from where we are right now, these numbers move up somewhat. But we wouldn't expect them to move up sharply.

And that would be a general theme in the credit portfolio. So I would say there is some risk of an increase, but not a significant risk and really no risk of a sharp spike based on what we're seeing right now.

In terms of the change in the impaired loans, most of the reduction would have come from write-offs in the quarter. Sales in the quarter were not significant. I think they were around $50 million.

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

One last quick one if I might. Any charge this quarter on marking to market your own debt?

Tom Flynn - BMO Financial Group - Chief Risk Officer

It's Tom Flynn. There was no net charge. There was a gain of about $23 million, which was offset by a hedge. So it was flat to the P&L in the quarter.

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

Thank you.

Operator

Darko Mihelic, CIBC.

Darko Mihelic ***- CIBC World Markets - Analyst***

Hi, thank you. Two questions actually. The first question with respect to your net interest margin discussion. You mentioned that part of the reason for the improvement in the net interest margin was related to the negative carry and the fix you effectively effected in Treasury.

I'm just curious how much of an impact was that? It sounds as though, reading through your MD&A, it sounds as though there could be more coming. So effectively what I'm angling at here is how much did that improve the NIM in the quarter? And do you think that there could be more improvement going forward? And how much?

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

It's Russ. To give a little history on this, as you recall, back in Q1, the one-to-three month issue, the interest rates number one were dropping quite quickly and the one-month rate dropping much more quickly than the three-month. Our fund transfer system, where we consistently charge the groups on a one-month basis, that difference in one and three ended up in corporate, and this related to all of our wholesale funding, and that was quite significant. It was improved in Q2 and then Q3, and it improved another $160 million of NII. So it's now down to a relatively small amount. We could see a little more improvement, but I wouldn't think it would be that significant compared to what we've seen in this quarter.

Darko Mihelic ***- CIBC World Markets - Analyst***

Okay, thank you. I think my second question also, Russ, may be for you as well. When we look at the adjusted -- the effective tax rate for the quarter, it was about 21% if we take out the general allowance and some of the notable items. That would compare to about 14.8% last quarter, to about 14.2% a year ago.

What can you tell us with respect to what we should be expecting on the tax rate for the Bank now? It sounds as though it's primarily due to lower income from lower tax jurisdictions. But can you give us any help on the tax line going forward?

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

Well, in this quarter, as you referred to, we did see some tax efficient transactions. We also saw, as you saw in the press release, in the Private Client Group $23 million recovery on settling some tax issues which drove the effective rate downwards.

I think going forward, we kind of shy away a bit from giving guidance on this, but 17% to 20% is still our view. Given the mix of income from low tax rate jurisdictions combined with our North American business, I think that would still be the guidance, Darko.

Darko Mihelic ***- CIBC World Markets - Analyst***

That's helpful. Thank you very much.

Operator

Jim Bantis, Credit Suisse.

Jim Bantis ***- Credit Suisse - Analyst***

Hi, good afternoon. A couple questions. Tom, when we think of the credit situation, I guess I am reading your comments or listening to your comments with respect to the losses moderating and we are obviously picking up the trend with respect to the formations declining, particularly out of the US.

Yet management chose to increase the general reserves. I'm wondering if you can kind of reconcile the moderation with the increase in general reserves.

Tom Flynn - BMO Financial Group - Chief Risk Officer

Sure. I think it's the difference between the direction of change and the pace of change, and we think there will likely be some upward pressure on the provision over the next few quarters. We don't see it moving up sharply, but we think there is potential for some upward pressure. And that reflects an economy that is still dealing with the effects of the recession and an unemployment rate that is still increasing.

So the increase in the general that we took reflects our view of the impact of the lingering effects of the recession on the credit portfolio.

Jim Bantis ***- Credit Suisse - Analyst***

Got it. So when we see $550 million in formations this quarter, we could probably expect that number to bounce around as opposed to continue to trend lower?

Tom Flynn - BMO Financial Group - Chief Risk Officer

I think that's fair to say. I think it will bounce around and could be a little bit higher one quarter and a little bit lower one quarter. But generally, there is still some negative migration in the portfolio, but the pace, both generally on the consumer side and on the commercial side, of the migration has slowed.

Jim Bantis ***- Credit Suisse - Analyst***

Got it. Thank you. My second question is regarding the profitability of the Bank. When you think of what I think, Bill, you had called as kind of more reflective of the Bank's earnings power, $3 billion in record profits, relatively low tax rate at 16%, the ROE seems light at 12%. I'm wondering if you can talk about what the sustainable return on equity is for the Bank.

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

Jim, I think you've touched on two things. One is the amount of capital; and clearly the Tier 1 capital ratio is very, very strong. That has delivered, as Russ said.

The environment going into 2009 was very uncertain. As you saw, 2009 started out pretty bumpy for markets as a whole. I still think there is still potential, although I think the potential is reducing, of a double dip or a second downturn in the economy.

We discount it because of the amount of stimulus that's coming into the US, still to come; but that's a possibility.

So I think maintaining a high capital level is a precaution. It's also a source of competitive advantage. As we get more visibility around the reduction in credit provisions, and they are still well elevated above their expected loss level, and you know that history has shown that provisions tend to spike, not ride on a high plateau for very long.

When we see some pace of reversals offsetting new formations, I think we'll have a clear view of some opportunities both to grow the balance sheet and to expand our business.

You know we've done a couple of small acquisitions in the last six or seven months that have been very positive, because the price at which we were able to do them and because they were assets that otherwise wouldn't have been available to be purchased.

So I think as far as the recovery in the return on equity of the Bank, that will come as the capital levels return to more normal levels and the provisions return to more normal levels. And you can do the math yourself pretty easily.

Jim Bantis ***- Credit Suisse - Analyst***

Thanks, Bill. No, I appreciate that. It's interesting when I look at your slide 8, and perhaps you are not intentionally signaling something. But you suggest that excess capital over a Tier 1 ratio of 8% is $6.5 billion. And coming from your previous comment it doesn't sound like Tier 1 ratios are declining in the near term. So that's just more of a calculation you're showing as opposed to indicative of what real excess capital is.

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

I think we're not signaling anything. What we are doing is showing that normal capital ratios -- and we still believe that an 8% Tier 1 floor is prudent for the Bank in this environment. Being at the floor is not our intention. But I do think that capital ratios in our industry will come back down from their current levels.

You have to remember that BMO and the other Canadian banks, but I'll speak specifically to BMO, went into the downturn with much stronger Tier 1 capital ratios than the US banks. And even stronger relative to the European banks.

So the normalization process that takes place I think will see our capital ratios come down as the environment normalizes. As to the rest of the world, they may in fact be much closer to our levels in the future.

Jim Bantis *- Credit Suisse - Analyst*

You had mentioned about using some of your capital towards acquisitions. A couple of your competitors have been tied to bank-assisted deals, whether it's in Ireland or in the south of the US. I'm just wondering if you can give us an update in terms the Bank's appetite in terms of their ability to price credit risk right now and look at doing a timely acquisition to build upon the Harris franchise?

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

Well, with respect to being able to price credit risk, I think that it's been a real benefit to have the stress test completed in the industry. It's provided a lot more visibility.

And with respect to valuing commercial loans, we do have a high degree of confidence in our own ability to evaluate credit and even to do it on a file-by-file basis.

So I think that it would be a reasonable thing for us to be involved in looking at FDIC-assisted transactions. As you know, in those deals you do have to absorb a portion of the credit loss. Basically you're paying for the deposits and then your purchase price is the expected loss.

So I hope that we'll see a good pipeline of transactions. So far there really haven't been that many, and we certainly haven't looked at banks that are not adjacent to or close to our current operating area. That's really the number-one limit.

And the second thing is, if we are going to acquire a bank through an FDIC process, we have to be satisfied that they have high-quality branches; that the customer base can be retained. Some of the banks that are in the process of being liquidated have very hot deposits. And you could acquire the buildings and not really have a core deposit base; and you'd be paying for deposits that you couldn't retain.

So I think that is the whole process that anyone who is acquisitive at this time has to go through. It's hard work. And then the banks have to be the banks that you really do want to own, not just because they are cheap, but because they are consistent with your strategy.

I know that sounds a little bit general, Jim, but it's actually very specific with respect to the way we're going about it.

Jim Bantis *- Credit Suisse - Analyst*

No, I appreciate the color. Thanks very much.

Operator

Robert Sedran, National Bank Financial.

Robert Sedran ***- National Bank Financial - Analyst***

Hello, good afternoon. Just a couple of quick housekeepers, actually. Russ, I know there's a lot of moving parts in the OCI line. But can you help me understand some of the bigger swing factors? Is the decline there all FX or is there something else I should be looking for?

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

(technical difficulty)…the translation of our net foreign operation, so that's all FX; and accumulated other comprehensive income; and then the hedging of the unrealized gain on the translation of foreign operations net of tax, $815 million, that is all FX.

Robert Sedran ***- National Bank Financial - Analyst***

Okay, and actually my line went dead for about 15 seconds there, so I guess I will just go back to the transcript.

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

I'll just say it's all FX.

Robert Sedran ***- National Bank Financial - Analyst***

Okay. Then just the other follow-up question, you mentioned the CVA and the mark-to-market losses largely offset. Is that why the CVA sort of wasn't called out as a notable item this quarter?

Can you give us a sense going forward, if we are in a period where maybe we are getting some reversals on previous writedowns, how you plan to treat these reversals in terms of adjusted earnings on a going forward basis? Is it a materiality question in order to get called out as a separate item?

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

Well, I think our view this quarter that our mark-to-market adjustments are relatively modest and they did, for the most part, offset. And therefore, was a view that it was not necessary to adjust the reported earnings.

Going forward, I think that will be a matter of what type of mark-to-market adjustments occur as to how we handle them.

Tom Flynn - BMO Financial Group - Chief Risk Officer

It's Tom Flynn. I'll add one thing. The two largest items that we had in the quarter were the CVA and the CDS item. And both of those are tied to credit spreads, and so they are highly correlated and they went in the opposite direction and net to basically zero. So that was part of the thinking behind not identifying them, the fact that they're both driven by the same thing.

Robert Sedran *- National Bank Financial - Analyst*

Correct me if I'm wrong, or help me understand, is that the treatment that would have been applied in prior periods as well? Because they would have been moving in opposite directions in prior periods, too, right?

Tom Flynn - BMO Financial Group - Chief Risk Officer

They generally would have been, that's right. So in prior periods we have on occasion identified them as items of note or whatever the term is. I think the key issue around whether we did or didn't related to the size.

In this quarter they were far smaller than they had been in a few of the recent quarters, and the net was de minimis, and so we just decided to keep it simple.

Robert Sedran *- National Bank Financial - Analyst*

Okay, I'm going to stop well short of asking for guidance on the trading line because I know it's impossible to do. But I guess based on those comments it sounds like the reported number is not far from what the actual number of the underlying business was, because those two items sort were both in the trading line and offset. Is that a fair comment?

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

Yes, it's Tom Milroy. I think that's a fair comment.

Robert Sedran *- National Bank Financial - Analyst*

Okay, thank you.

Operator

Brad Smith, Blackmont Capital.

Brad Smith *- Blackmont Capital - Analyst*

Thanks very much. My question relates to note 4 in your shareholders report, page 36, under securitization. I was just wondering if I could get a little bit of better clarity with respect to the generation of gains related to the revolving credit card securitization vehicles. The note is kind of showing that there is no activity; and I think there is a sub note there that confirms that there were no new securitizations.

But there continued to be gains. And these numbers at $116 million this quarter and $120-odd-million last quarter and the quarter before are quite large numbers relative to the earnings of the Bank. And they're also large numbers relative to the balance or the amount of rollover or revolving in the vehicles.

Can you talk a little bit about the economics and the sustainability of these numbers?

Russ Robertson *- BMO Financial Group - CFO*

It's Russ. I'll give you the accounting and if Frank wants to give any color on this. But the securitization, as you'll see, is -- well, $4.5 billion is the outstandings in the credit card. And of course, they pay off very quickly. We undertake to top up those vehicles as they pay down. So those gains that you see relate to the credit cards that we sell into those vehicles on a continual basis.

That's why they are fairly significant and that will continue as long as we maintain those trusts at $4.5 billion.

Brad Smith *- Blackmont Capital - Analyst*

So the $116 million, that is a gain related to not the 4.7, but to the proportion of rollover effectively. Can you just give us a sense of what that proportion was?

Russ Robertson *- BMO Financial Group - CFO*

We would have to get back to you on that.

Brad Smith *- Blackmont Capital - Analyst*

Something less than 4.7?

Russ Robertson *- BMO Financial Group - CFO*

It's related to the amount that would be topped up; and as you -- we'll get back to you on the exact numbers. But obviously credit card receivables pay off quite quickly, so there is a sizable amount of top-up that would occur in every quarter.

Tom Flynn just has a point here.

Tom Flynn - BMO Financial Group - Chief Risk Officer

Yes, it's Tom Flynn. I'll just add one thing. The gains on the credit card top-up sales are larger than they are on the mortgage top-up sales because the spreads are much higher on the credit card product. So with the higher spread you get a higher gain when you put the assets into the securitization vehicles.

Brad Smith *- Blackmont Capital - Analyst*

Right, and that just sort of brings me to my next question, which is -- I mean, the proportion of credit card loans at 4.7 is almost more than double your on-balance sheet position now, and that's up very substantially over the last couple of years. And yet reported net interest margins for the Bank are also up.

Since these are high spread loans, the fact that margins for the Bank can increase at the time that you are shunting high spread loans off balance sheet and generating gains, can you reconcile that for me? That just seems that kind of counter current there.

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

Brad it's Frank. I'll take a crack from the P&C perspective. And this message is consistent with prior quarters, and I don't know how else to come at this. But if you look at what's been going on for the last four, five, or six quarters, our deposits have been growing much more rapidly than our loans. In year-over-year for instance, our deposits are up $10.9 billion and our loans are down $ 2.4 billion. That's going to have a large impact on net interest margin.

If you think about what's going on in our loan portfolio, we have had a change in mix in our loan portfolio. Our consumer loans at higher spreads are growing much more rapidly than our mortgage loans at lower spreads.

On top of that, we have initiated this year some pretty significant repricing both on the consumer portfolio and on the commercial portfolio. So while we have seen in the P&C business an increase in our net interest margin and it's been relatively high, 33 basis points year-over-year, we have had a significant change in the dynamics of the business over that period of time as well.

So it is all three of those factors that are having an impact. And obviously the securitization activities is having an impact on the denominator; but there is also other major differences in the business today than we've seen in the past.

Brad Smith ***- Blackmont Capital - Analyst***

So, Frank, in other words, if you hadn't securitized an additional $1.5 billion or so in credit card loans, then the Bank's margins would be that much greater today and would have increased by that much more over the last six, eight quarters. Is that what you're saying, effectively?

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

I'm looking at Russ for the answer to that question.

Tom Flynn - BMO Financial Group - Chief Risk Officer

It's Tom Flynn. I'll jump in. I think the answer to your question is yes; but there is a further add to it. If we hadn't securitized credit card loans, the margin would have been higher. However, we've also securitized very significant amounts of mortgages, as have all of the Canadian banks. And mortgages have a relatively low spread compared to both cards and our portfolio in general. So that has had a negative impact.

That's inflated the net interest margin, and so those two items will offset each other. So you can't just look at the impact of the cards in isolation. The mortgages, because they're a lower spread product and we have securitized a lot of them, would have had a meaningful impact on the overall margin as well and a positive impact.

Brad Smith ***- Blackmont Capital - Analyst***

Okay. My last question just on this note 4, there is no statistics related to weighted average life prepayment interest rate etc. under the July column. I understand because those vehicles are all in place. Are we to assume that those estimates have remained unchanged and they're driving the $116 million?

Tom Flynn - BMO Financial Group - Chief Risk Officer

Yes, there would not have been a material change.

Brad Smith ***- Blackmont Capital - Analyst***

Okay, thanks very much.

Operator

Sumit Malhotra, Macquarie Capital.

Sumit Malhotra ***- Macquarie Research - Analyst***

Good afternoon. For Tom Flynn, if we go to slide 26 of the Russ Robertson slides, just want to go back to this credit valuation adjustment and how it affected trading. You have a couple of days here at the end of May, the end of July, in which you had about $130 million in CVA-related trading revenue come through.

Am I correct in assuming that's roughly what we're looking at here? That was the bulk of the CVA gains in the quarter. If that's accurate, and if the CDS mark-to-market losses also went through trading, shouldn't we see days of large proportionate losses to offset that? Am I thinking about that the right way?

Tom Flynn - BMO Financial Group - Chief Risk Officer

Let me try to explain the page and see if it helps. We have got large gains, as you've noted, at the end of May and at the end of July. They total about $130 million.

We book the CVA at quarter end. The CVA for the quarter as we've disclosed was $61 million, and of that we booked about around $90 million at the end of May and at the end of July. So the majority of the amounts that you're seeing would relate to the CVA. There was a negative CVA in the month of June.

In addition, in May when we had a CVA of $23 million against the total revenue of about $80 million we had some positions that are valued monthly that benefited from tighter credit spreads; and that produced gains that are included in the $80 million. And we also had some adjustments to some of the holdbacks that we have on the valuation of the trading books, and that's in the $80 million as well.

Sumit Malhotra ***- Macquarie Research - Analyst***

Okay, so these two large ones you are saying stand out; but the net -- or the gross CVA gain in the quarter was around $60 million and I think you said a couple times the MTM loss was around $70 million.

Tom Flynn - BMO Financial Group - Chief Risk Officer

That's correct.

Sumit Malhotra ***- Macquarie Research - Analyst***

Okay, and maybe just these two stand out because they look so big. One more and we can leave it there. This might be for Bill.

Capital ratios obviously have benefited from the RWA decline and currencies played a role. It hurt you in Q4, it helped you in Q2 or Q3. There was a comment that capital ratio should decline as loan growth increases.

A few comments throughout the MD&A that, especially on the business lending side, and this is normal in this kind of environment, we are not seeing too much growth. Could you maybe give us an overview on how the Bank is feeling in terms of its overall organic loan growth here, ex of currency? What do the trends look like?

And are there market share gains that the Bank is picking up either in Canada or the US from the withdrawal or the removal of certain competitors?

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

That's a good question and I'm glad we had a chance to finish on the momentum in the businesses, Sumit. There are going to be opportunities. Certainly Frank has spoken about the growth that we have seen in the higher spread lending products in personal banking in Canada. And I think on the commercial side we do expect to see demand for credit recover. You have to remember that particularly with respect to commercial banking, when the economy starts to grow again, there is a big portion of the market that was providing credit that is no longer there, or is certainly somewhat limited.

So the demand on bank balance sheets with respect to this notion of re-intermediation, portions of the asset securitization market that have gone away, is real. So I think we will see commercial loan growth in Canada first, and then we'll see commercial loan growth in the US.

Right now in the US, I think that it's clear, at least in our customer base, that the quality of earnings has been improving because of a heavy focus on cost control and a lower level of reinvestment. But when the recovery starts, I think you'll see a pickup in investment, a rebuilding of inventory, and a call on working capital.

So we do think we will see some growth in commercial loans balances. We're certainly seeing in the large corporate market as facilities come up for renewal or even as maturities in the term market come in, there are opportunities to refinance with bank financing at much wider spreads. So I do think there is an opportunity for organic growth in the balance sheet, but it's not going to be fast, and I would look into 2010 for that.

Sumit Malhotra *- Macquarie Research - Analyst*

Thanks for your time.

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

That was the last of the questions, operator?

Operator

Yes, this concludes the question and answer session.

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

Okay. Well, thanks very much, and I want to thank everyone who participated in the calls. We were happy to be able to have the opportunity to provide clarification. If you have follow-up questions, by all means please give Viki a call.

Before we sign off I just want to reiterate the three primary messages that I think define the quarter. The first one is that our customer-focused strategy is working, and I'm happy to confirm that we're staying with it. Customers' needs are evolving every day; we believe there is an opportunity to provide new products and responsive service that will deepen relationships. There is no better time to build client relationships than this point in the cycle. There is no better time to increase loyalty. And in truth, there is no better time to lay the foundation for growing the Bank.

We are very pleased with the results that we have achieved to date. I think that the first three quarters of this year are good evidence of emerging strength. But we're not satisfied.

The second thing is that we've been able to continue to invest in our front-line and we've been able to continue to invest in customer-related initiatives and at the same time keep a very tight control on discretionary spending. And that gives us an advantage as we start to see an expansion.

And the third one and this goes to the last question, there are going to be opportunities to generate superior growth as growth returns. Having a strong balance sheet and four core businesses that we have a high degree of confidence in is the place that we want to be. We're well positioned to participate as these opportunities do emerge.

Thanks again for joining us today. We look forward to speaking to you at the end of the fiscal year. Good afternoon.