Q3 2012 CONFERENCE CALL

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PRESENTATION

Sharon Haward-Laird - Head of IR - BMO Financial Group

Good afternoon everyone, and thanks for joining us today. Our agenda for today's investor presentation is as follows. We will begin the call with remarks from Bill Downe, BMO's CEO, followed by presentations from Tom Flynn, the bank's Chief Financial Officer and Surjit Rajpal, our Chief Risk Officer. After their presentations, we will have a short question and answer period where we will take questions from pre-qualified analysts. To give everyone an opportunity to participate, please keep it to one or two questions and then re-queue. Also with us this afternoon to take questions are BMO's business units heads, Tom Milroy for BMO Capital Markets, Gilles Ouellette from the Private Client Group, Frank Techar, Head of P&C Canada and Mark Furlong, Head of P&C US.

At this time I caution our listeners by stating the following on behalf of those speaking today. Forward-looking statements may be made during this call. They are subject to risks and uncertainties. Actual results could differ materially from forecasts, projections or conclusions in the forward-looking statements. Information about material factors that could cause results to differ and the material factors and assumptions underlying these forward-looking statements can be found in our annual MD & A and our third quarter report to shareholders. With that said, I will hand things over to Bill.

Bill Downe - President & CEO, BMO Financial Group

Thank you Sharon, and good afternoon everyone. BMO produced strong financial results in the third quarter as our business continues to deliver consistent, attractive profitability within a sound risk framework. The bank's reported net income increased 37% year over year to $970 million, or $1.42 per share.

On an adjusted basis, net income was up 18% to over $1 billion, representing $1.49 per share [1], 11% ahead of last year. Revenue growth[1] was 9% reflecting acquisitions and organic growth across our business, BMO's ROE was 15.2%.

Adjusted provisions for credit loss were down from last year benefiting from a good core performance and our strong loan workout capabilities. Surjit will give you more detail on credit later in the call.

BMO continued to build on its strong capital position in the quarter, assuming full implementation of Basel III reforms and full impact of IFRS, our pro forma Basel III common equity ratio was 8.3%. We increased our quarterly dividend by 3% to $0.72 a share, reflecting our strong capital position, the success of our business strategies and our confidence in our continued ability to generate sustained earnings growth. We also moved the target dividend payout range to between 40% and 50% of income. This change is consistent with our objective of maintaining capital flexibility to execute on our growth strategies and acknowledges the higher capital expectations resulting from Basel III.

Confirming the confidence we expressed during our US Investor Day in June, this quarter's earnings reflect strong performance from our US businesses. There's good momentum in US personal and commercial banking as we continue to generate organic commercial loan growth and execute well against our plans. And there was improved performance in both Capital Markets and the Private Client Group. In addition, we continue to simplify our organization and processes throughout the Company. Our focus on expense management has gained traction throughout the bank and the results are visible. In the quarter, adjusted expenses declined sequentially and also year over year after adjusting for acquisitions and the stronger US dollar.

We've been effective in identifying efficiencies while making investments to expand our value proposition and make things easier for our customers. Here are three examples:

In May, BMO became the first major financial institution with the capability to offer real-time appointment booking through our website. This service delivers on our customer promise by enabling existing and prospective customers to book their own appointments at a time convenient for them at any BMO branch across Canada. We've also developed more flexible retail store models. This strategy, comprising small Studio, midsize Neighbourhood and large Metropolitan formats, has created more productive and customer friendly branches. The benefits of this approach include reductions in real estate space, capital investment and operating expenses, faster revenue growth and a quicker time to positive contribution, and our customers appreciate the difference.

1 - Reported EPS $1.42 per share, 30% ahead of last year; Reported revenue growth was 17%

Third, we've implemented new technology architecture for the bank which links together key systems to generate significant benefits in customer experience and productivity. We've reduced the cost to build new products and services and improved our speed to market, by making it easier to use off the shelf applications and reuse software components. In addition, by providing a clearer picture of customer interactions, it facilitates our effective cross-sell.

Here is what these programs have in common: We're investing in a way that's meaningful to customers. Investments are designed to set BMO apart and reinforce the brand commitments we've made, and this is a theme that runs through the entirety of our productivity improvement work, the goal of enhancing the experience for our customers, and making it easier to do business with us also reduces expenses.

Turning now to our operating groups, P&C Canada's reported net income for the third quarter was $453 million and on an actual loss basis, up 5%. There was good volume growth across most product lines, including residential mortgages. With the promotion which began about two years ago of BMO's five year fixed rate 25 year amortization mortgage, we've been at the forefront of a significant change in the structure of the Canadian residential mortgage market.

We introduced the product because we saw it as a substantial benefit to customers, providing them with a faster path to increased home equity and certainty of monthly payments. With the success of this mortgage, we've seen above average credit quality and importantly, the proportion of mortgages approved that are ultimately closed has also risen. We've attracted new customers and established a foundation for productive long term relationships. I might add that the recent changes to Canada's mortgage market announced by the Minister of Finance were prudent, responsible and timely, and they align with BMO's risk practices and ongoing efforts to encourage Canadians to borrow smartly.

P&C US reported net income of $127 million in source currency and on an adjusted basis, net income[1] was $143 million, up 4% quarter over quarter. Commercial and industrial loans were up 10% from the end of last year, and the pipeline remains strong.

Private Client Group, adjusted net income[1] was $115 million in the third quarter as good underlying business performance was offset by unfavorable impact of long term interest rates on insurance. Our Exchange Traded Funds business marked its three year anniversary this quarter by surpassing $6 billion in assets under management, up 62% for the first half of the calendar year. This rapid growth is attributable to our ability to anticipate investors' needs and our commitment to ongoing innovation, combined with the strength and experience of our team.

Going forward, we'll continue to maintain this commitment to innovation and strong expertise while remaining true to the original ETF concept of simplicity, transparency, and cost effectiveness to meet our client needs.

BMO Harris Private Banking was named the best private bank in Canada for the second consecutive year by World Finance. This recognition is a clear demonstration of the quality of our client relationships.

BMO Capital Markets delivered good performance with net income of $232 million, up quarter over quarter due to higher revenues and down from a strong quarter a year ago. These results reflect the benefits of the diversified revenue mix of our capital markets business. During the quarter we were named best investment bank in Canada for 2012 by World Finance. We also won Trade Finance Magazine's Best Trade Bank in Canada award for the third year in a row.

To wrap up, we've delivered $3 billion in adjusted net income[1] through the first nine months of the year. Each of our businesses is delivering on an improved customer experience and is on track to finish the year with strong performance in a highly competitive environment. And with that Tom, I'll turn it over to you.

Tom Flynn - EVP & CFO - BMO Financial Group

Thanks Bill, and good afternoon, everyone. I'll start on slide 7. BMO had a strong financial quarter with good operating group performance. Reported net income of $970 million was up 37% from last year. On an adjusted basis, net income was $1 billion, up 18%, EPS[1] was $1.49, up 11%, and ROE[1] was 15.2%. Our capital position also strengthened again this quarter.

There was earnings growth across the operating groups with retail businesses up over 10% from a year ago on an adjusted basis. Capital Markets delivered good earnings in the quarter of $232 million. Adjusted results absorbed a negative impact of $0.07 per share in our insurance operations due to the impact of lower long-term interest rates.

1 - P&C US reported net income up 4.7% Q/QPCG reported Net Income was $109MM; Reported Net Income $3.1B through first nine months;
EPS was $1.42, up 30% from last year, and ROE was 14.5%

Disciplined expense management contributed to essentially flat expenses year over year, excluding the impact of acquired businesses and the stronger US dollar. Expenses were down quarter over quarter. Adjusted provisions for credit losses were lower year over year and relatively stable quarter over quarter. Surjit will provide more color in this area in a moment. And lastly, the tax rate was down in the quarter.

Items removed to arrive at adjusted income were similar in character to prior quarters and totaled $43 million, or $0.07 per share in the third quarter. Slide 11 shows the details on these items.

Moving to slide 8, adjusted revenue[1] was $3.7 billion, up 8.8% year over year with growth in all retail businesses. Year over year growth was primarily driven by acquisitions. On an adjusted basis, net interest income[1] was up 11% and non-interest revenue[1] was up 7%. Quarter over quarter, net interest income[1] was up 2% due to volume growth and two more days in the current quarter.

Non-interest revenue[1] declined 5% sequentially due to the impact of interest rates in the insurance business and lower non-trading security gains which were below the levels that we've had in previous quarters over the last year. As shown in the graph on the right, adjusted total bank margin[1] excluding trading was 203 basis points, down 7 basis points quarter over quarter primarily due to P&C Canada and BMO Capital Markets.

The decline in P&C Canada was primarily due to deposit spread compression in the low rate environment, lower personal lending margins resulting from competitive pressures and customer behaviors in the card business and loan growth exceeding deposit growth, particularly with mortgages. BMO Capital Market's margins were down due to lower market spreads.

Turning to slide 9, adjusted expense trends show the benefit of our focus on productivity. Expenses[1] of $2.3 billion were up year over year, largely due to acquisitions. Excluding the impact of acquisitions and the stronger US dollar, expenses were essentially flat year over year. Quarter over quarter adjusted expenses[1] declined 0.6% despite the effect of two more days in the current quarter. Expenses were down 1.5% in the quarter after adjusting for the stronger US dollar.

As shown on slide 10, capital ratios strengthened in the quarter with the common equity ratio very strong at 10.3% and the tier 1 ratio at 12.4%. Our pro forma Basel III common equity ratio moved up to a strong 8.3% in the quarter. This number includes the full impact of adopting IFRS not the lower phased in impact that is used for the Basel II ratios.

Moving to slide 13, P&C Canada net income was $453 million with higher volumes across most products partially offset by lower margins. There was good loan growth in the quarter with personal lending balances up 6.3% and commercial loans up 6.6% from last year. There was also good sequential loan growth with total loans up 2.9% from last quarter, confirming our optimism expressed in the second quarter. Our market share increased across all personal loan and deposit products.

Factors impacting NIM are noted on the slide. I mentioned these in my earlier comments on slide 8. Lastly, expenses were well contained as we actively managed productivity while investing in the business.

Moving to slide 14, P&C US adjusted net income[1] was US$143 million. Revenue and net income growth year over year was strong, reflecting the benefit of acquisitions. Revenue of US$739 million was relatively flat quarter over quarter, and margins were up 3 basis points. Expenses were down 1% quarter over quarter and are being closely managed. There continues to be good growth in our core C&I balances. These balances are up 10.2% since Q4 2011, and the pipeline remains strong.

Turning to slide 15, Private Client Group adjusted net income[1] was $115 million, up 8% from a year ago. Revenue growth was 9% year over year. Quarter over quarter revenue and net income were down due to the $45 million after-tax impact of lower long-term interest rates in the insurance business.

Turning to slide 16, BMO Capital Markets delivered good results with net income of $232 million and ROE of 19.3%. Earnings were up quarter over quarter due to better trading and corporate banking revenues and debt underwriting fees. Revenues were down slightly from strong levels a year ago. The productivity ratio was 59.6% in the quarter.

Turning now to slide 17, Corporate had reported net income of $47 million and adjusted net income of $65 million. Year over year, adjusted net income[1] was up $127 million, mainly due to lower provisions for credit losses. Quarter over quarter, adjusted net income[1] was up $44 million, lower PCLs, expenses and taxes were partially offset by a decline in revenues. To conclude, we're pleased with our performance in the quarter, and we feel good about how our businesses are performing and positioned looking ahead.

1 - Reported revenue was $3.9 billion, up 17% Y/Y ; Reported Net interest income was up 23% Y/Y; Non-interest revenue was up 7% Y/Y;
Net interest income was up 5% Q/Q; Non-interest revenue declined 10% sequentially;Reported NIM was 188 basis points down 1bps Q/Q;
Reported expenses of $2.5B; Q/Q reported expenses declined 0.6%; P&C US Reported Net Income was US$127MM;
PCG Reported net income was $109MM, up 5.7% Y/Y; Corporate Net income was up $246MMY/Y and down $44MM Q/Q

And with that, I'll turn things over to Surjit.

Surjit Rajpal - EVP & CRO - BMO Financial Group

Thanks Tom, and good afternoon. I'll focus my comments on a few key areas of interest, beginning with the provision for credit loss on slide 24.

The total provision for credit loss this quarter was $237 million, $116 million on an adjusted basis. Consistent with previous quarters, I'll comment separately on the legacy and acquired portfolio.

In the legacy portfolio, the current quarter specific provision for credit loss was $234 million compared with $268 million in Q2. P&C Canada, US consumer, and Capital Markets all contributed to the improvement. On the purchased credit impaired portfolio there was a recovery again this quarter of $118 million compared to a recovery of $117 million in the second quarter.

As we noted in Q2, the recovery reflects our proactive management of this segment of the purchased portfolio. This portfolio has reduced significantly since acquisition, and we expect some reduction of the recoveries in the segment going forward.

The provision in the purchased performing portfolio was $113 million during the quarter and was approximately one-third consumer and two-thirds commercial. The provision has increased from $44 million in the second quarter, which is in line with expectations as losses emerge from this portfolio. I would remind you that there will be timing differences between when losses in the purchased performing portfolio occur and when we recognize the mark through income.

Turning now to the impaired loan formations on slide 26, in the legacy portfolio formations of $405 million this quarter compared to $455 million in Q2, with the largest decrease coming from the consumer book. The impaired loan formations from the purchased performing portfolio decreased to $386 million this quarter compared to $444 million in Q2. Impairment in the purchased performing loans and any potential losses on these, were adequately provided for in the credit market recorded at acquisition.

Before I close, I would like to provide some comments on the integration of the M&I acquisition. It has been one year since the purchase, and I'm pleased with the progress. We have aligned the credit culture and successfully integrated our framework, policies and processes. Our strategy to reduce stressed commercial real estate portfolios has resulted in the reduction of almost 40% from the time of acquisition. As well, risk teams are fully engaged in insuring seamless technology integration. Finally, the legacy portfolio continues to perform well as the North American economy slowly improves, and our purchased portfolio is performing in line with expectations. Thank you, and we will now turn it over to the operator for the question and answer portion of today's presentation.

QUESTION AND ANSWER

Operator

(Operator Instructions)

The first question is from Peter Routledge from National Bank Financial. Please go ahead.

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

Yes, thanks very much. Bill, a question for you, maybe you could just go into a little bit about the board's thinking behind lowering the target payout range. Does that mean the cost of organic growth in terms of retained earnings is going up?

Bill Downe - President & CEO, BMO Financial Group

Well, I'll comment on what our thought process was. I'm not sure I follow what you just said, but I'm sure we'll have a chance to catch up later on that one. The thinking was really very straightforward around the payout target range. The businesses have very clear opportunities for reinvestment, organic investment in the businesses, and our range was outside the norm within the industry. And as we see growth opportunities, particularly as we've gotten through the integration process in the US, with the large acquisition we made 18 months ago, and we felt this was a more appropriate range for the future. I also think, as I said in my comments, it's a reflection of capital management in the post-Basel III environment.

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

So, what I was getting at with the way I framed the question, which is with likely rising minimum Basel III common equity ratio over time, as OSFI rolls in the domestic systemically important buffer and leverage ratio due to come in I guess two years now, does that mean for every dollar of earnings you have to hold back a little bit more to manage through that headwind?

Bill Downe - President & CEO, BMO Financial Group

No, I don't think so necessarily. If you reflect on where we were at the end of the fourth quarter 2010, we had a very clear line of sight on the B-III ratio on a pro forma basis. And we acknowledged that it was going to be significantly reduced when we closed M&I. It was in the mid 8%-plus range prior to the announcement [sic] of the transaction, went down below 7%. And the capital generation capacity of the bank has really been demonstrated by the fact that we rebuilt it, and we're able to report a number of 8.3% this quarter. So I think we have a lot of confidence in the earnings generation ability and support of capital at this point, and I think relative to all of the guidance we've given around capital, we've brought the ratio back to a level that we had indicated was our intent.

I think that above and beyond that though, it is important to maintain strong capital.

It's also, at a time like this that there really are opportunities to build the client base across the businesses, and we've made a number of really good acquisitions in wealth management as well as the acquisitions we've made in personal banking and commercial banking. We have an opportunity to invest in those businesses now, and we think the return to shareholders of that investment strategy is going to be viewed very positively. So, we just wanted to have that in balance, the earnings to support the maintenance of capital and the building of the investment plan.

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

If a property came into play, a property in your footprint you'd certainly not have to pass on it due to capital. You have ample capital to consider. That fair?

Bill Downe - President & CEO, BMO Financial Group

Yes, I think that's right.

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

Thanks.

Operator

Thank you. The following question is from Gabriel Dechaine of Credit Suisse. Please go ahead.

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

Hi, good afternoon. Another capital question here, the DRIP. It was responsible for 3.7 million shares or so issued this quarter. Given your capital position, I just don't see the point of maintaining the DRIP. What's your view on that? And maybe given some of your comments about capital to fund growth that's hoping for a buyback is a little bit farfetched at this stage. I've got a follow-up on the mortgage business for Frank.

Tom Flynn - EVP & CFO - BMO Financial Group

It's Tom. I'll take the first part of the question. On the DRIP, I think the answer is we agree with you and we do plan on discontinuing the DRIP, and there was a statement to that effect in the capital section of the body of the press release. And so the discount on the DRIP is discontinued, and that drives the majority of the capital that is issued under the DRIP. We think it's appropriate to maintain the DRIP for share holders without the discount because some shareholders like to have the ability to continue to invest in the stock in an easy way, so as a mechanic, we think it's appropriate to keep that open. On the buyback side, again, I think our thinking is aligned with yours and we would consider that at this point to be premature. We are very comfortable with the capital position, and it clearly strengthened nicely in the quarter, so we feel good with where we sit. And with that, I will hand it over to Frank for a response on the mortgage part of the question.

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

Well I haven't asked it yet, so I'll go ahead now. Very healthy mortgage growth, and it looks positive, but given all of the headlines we're hearing about consumer indebtedness, I just want to know what your thinking is about pushing for mortgage growth. Is this something that you're just able to take advantage of some peers that are pulling back in the marketplace? Should we expect that your market share numbers will be going up over the next few quarters? And just in terms of the origination mix, how much of it's insured versus uninsured? And of the uninsured portion, what would be the average LTV? I don't know if you can have that off the top of your head, but I would like a follow-up at some point.

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

Okay, Gabriel, thanks. Maybe we can follow-up on the nature of the business, but we were really pleased with the mortgage growth, I think it's pretty simple. We had a great spring campaign, and we saw those mortgages book in Q3. We saw some growth in Q2, and the way the market typically works is Q3 is the strongest quarter overall and we did really well on the back of our 5 year fixed rate, 25 year amortization product promotion in the marketplace that Bill already mentioned. And our objective was to promote a product that was in our customers' best interest, pay less interest and pay off their mortgage faster. We benefited because we now have customers who are going to be with us for a while, and we saw a significant increase in new customers coming to BMO through the campaign as well. So putting a fine point on it, our market share went up 21 basis points in Q3, so we did more business than some of our competitors. It's obviously an important product to us as it is to others, and we just think we had a really strong quarter and our expectation is we'll see a little softening in Q4. Q4 is not typically a strong mortgage quarter, but we're going to compete really strongly going forward.

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

So it's more what you're doing, not at an instance of competitors pulling back then?

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

That's what I think. I think there's a question about, has there been a little bit of an acceleration of activity in the marketplace? That wouldn't be our view. Our view would be we haven't seen any of that, and we think our strong growth is as a result of the tactics that we've employed.

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

Okay, thanks a lot.

Operator

Thank you. The following question is from Cheryl Pate of Morgan Stanley.

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

Hi good afternoon. Another question for Frank on the net interest margin in P&C Canada. Wondering if you can give us some color on how much of the 7 basis points is driven by the lower personal lending margins and within that, how much campaigns such as the 2.99% mortgage is impacting the personal lending margins. And then just more color on the customer behavior in the card business in particular would be great, thanks.

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

Okay, thanks, Cheryl. I'll take a few minutes on this one, if I can. The margin decline that we saw in the quarter was more than we expected. As Tom mentioned, it was driven by four things, two that we expected and two maybe that we didn't anticipate. We did expect to see competitive pressures to continue, in particular in the consumer lending space. We expected deposit spread compression in our continuing low interest rate environment. We didn't expect to see the level of restraint our credit card customers showed us this quarter. Revolving balances were much lower for us than we had forecast. And in addition, the impact of our stronger loan growth, loans growing faster than deposits also depressed margins more than expected. So, those four reasons, Cheryl, to get directly to your question, all contributed about equally to the 7 basis point decline that we saw sequentially.

The good news in this is that we did see strong growth in mortgages, as I've already mentioned, and this growth in relatively lower spread assets did have a small impact on margins And in a way, this is a give back to the large spread expansion that we saw in 2009 and 2010 when we exited the broker channel. If you'll recall, our margins expanded 36 basis points during that timeframe. So, with stronger mortgage growth, we're going to see some softening in the margin. That had some impact, but as I said, it was just one of four factors. And I just do want to mention one more time that spreads on our 2.99% product were less than 10 basis points lower than our portfolio spreads, and they did not have a meaningful impact on the compression that we saw in this quarter. Hopefully that helps you out.

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

Thanks, that's really helpful.

Operator

Thank you. The following question is from John Reucassel of BMO Capital Markets. Please go ahead.

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

Thank you. Frank, I'll stick with you or maybe Surjit. If I look at slide 28 which shows your insured versus uninsured, and it does show that your uninsured portfolio mortgage grew, but that the LTVs stayed the same for the overall portfolio. Frank, could you just confirm to me that it was about 56% on origination, and how much of this took the 25 year amort versus other products?

Surjit Rajpal - EVP & CRO - BMO Financial Group

Why don't I start and then Frank can talk about the 25 year amort products. You have to understand, quarter over quarter with a $3.4 billion shift, it doesn't change the overall portion too much. But let me tell you why the uninsured portfolio is still roughly at about the same level. The uninsured portfolio actually is, if you look at it, the uninsured portfolio right now is a little higher than it was in the last quarter, and the reason for that is that the new originations that we've had have been lower loan to value originations and that really doesn't require you to have insurance, so that's one reason. The other reason is that we didn't securitize anything on which typically we take bulk insurance, so that's one of the reasons why our uninsured actually has gone up in terms of the relative size of our portfolio.

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

And that all makes sense to me, Surjit, but the new loans, the new mortgages you're getting, the LTVs are in the 55%, 56% range?

Surjit Rajpal - EVP & CRO - BMO Financial Group

Yes, I'm going to ask Frank to confirm that, but yes, they are slightly more conservative than they have been in the past.

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

And I guess what portion chose the 25 year amort versus other mortgage products?

Surjit Rajpal - EVP & CRO - BMO Financial Group

The new origination is entirely 25 year amort. [sic]

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

All of it, okay. So, the quality of the customer, the quality of the loan you're making still quite good, even though some might argue that the quality of the customer is going down given where we are with leverage metrics across the country; is that fair?

Surjit Rajpal - EVP & CRO - BMO Financial Group

That's fair. Let me give you some flavor I think the quality of the client we've seen as part of this new program that we had actually was higher, better. And one of the reasons, I guess, and Frank can correct me if I'm wrong, but I think I'm probably in the right zone answering this question, people who actually wanted to maximize their leverage, weren't of the ones that borrowed. The people who borrowed were the ones that actually really needed to borrow, and were quite comfortable with the new 25 year amortization rule. Frank, anything to add to that?

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

Yes, just a couple of things. On the 2.99% offer, the credit quality, as Surjit said, was better than our other mortgages that we were originating during the same period and our portfolio averages. Bureau scores were much higher and we saw a lower percentage of investor owned and condo purchasers with our 2.99% offer. So, not only did we ramp up our portfolio growth, but we did it with really improving credit quality for those customers.

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

Okay, and just last question divided between Surjit and Frank is, Surjit, it's interesting only 50% of the mortgages in BC are insured. Is there something about BC or BC portfolio that's different from the rest? And then for Frank, you mentioned that Q4 is a seasonally slow quarter for originations or mortgages, but what about the impact of the new OSFI guidelines and the new mortgage insurance rules? Are you starting to see that impact at all at this stage?

Surjit Rajpal - EVP & CRO - BMO Financial Group

I'll take your first question with respect to the large uninsured in BC. The reason really for that is that in BC, we have higher equity in those transactions, so we have lower loan to value loans. And one of the reasons for that is because the new immigrant non-resident program is more active there, and these borrowers typically will put in a larger amount of equity and so that skews the uninsured portion of our BC portfolio.

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

Thank you.

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

Yes, the only thing I'd add is Q4 is a slower quarter. I don't know what the words you use to describe it, but it's slower than the third quarter. We are going to see mortgage activity in the quarter. Relative to what's going on in the market and the guidelines, we're expecting a bit of a slowdown, but we are not expecting a big change. The way I would characterize it is that people are going to continue to buy homes. They might not be stretching quite as far on price or the value of the property based on the guidelines, but we do think the mortgage market continues to be relatively balanced across the country from a supply/demand perspective, and therefore we're not anticipating a big change in that dynamic as we go through the next couple of quarters.

We have seen obviously some slowing in Vancouver and the GTA, and I'd put that in the healthy category. Everybody I think was hoping we would see a bit of a soft landing, a bit of a slowdown in those two marketplaces and we've seen that. My view is it's a pretty balanced marketplace. We might see a little slowing. I don't think it's going to be material.

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

Thank you.

Operator

Thank you. The following question is from Michael Goldberg of Desjardins Securities.

Michael Goldberg - *Desjardins Securities - Analyst*

Thanks, I have a number of questions, two to start out with. How much did the change in the Ontario tax rate impact third quarter earnings?

Tom Flynn - EVP & CFO - BMO Financial Group

It's Tom Flynn, Michael. The proposed change to the Ontario tax rate did con tribute to the tax rate that we had in the quarter and it lowered the tax rate by about 0.8%.

Michael Goldberg - *Desjardins Securities - Analyst*

Can you put that in dollar terms?

Tom Flynn - EVP & CFO - BMO Financial Group

It would be, I think under $10 million.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay, so it's not really material. Okay more generally, there's been a lot of fear about slower business growth and intensified competition in Canada, so broadly speaking from what you've see n, have thing s turned out to be le ss than expected, greater than expected, or roughly in line with expectations? And if it's been less than expected, do you think it's going to intensify?

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

Michael, it's Frank. Not quite sure what you're actually trying to get at. My view on the competitive environment at this point in time is it's in line. I mentioned that in my mortgage comment. I think the markets are pretty balanced. We saw one element of o ur margin co mpression this quarter was the competitive dynamic, and our ex pectation is that's goi ng to continue. But I'm not seeing an acceleration of any kind, or at least we didn't see that in Q3.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay, and my last question, there seems to be evidence of a pick up in US house prices. What impact should this have on your purchased US portfolio and the outlook for US business more generally?

Mark Furlong - President & CEO - BMO Harris Bank, N.A

This is Mark Furlong. On the mortgage side, we've continued to see pretty goo d volume and rates have stayed relatively low. And th e projection was rates would go up a little bit, MBA had come out with a projection that had the purchase of market next year being about 38%. That was in July; by August, they'd already changed it to 48%, and rates continue to stay low. So, I'd say that the mortgage market's going to continue to be real strong thro ugh 2013; and the open acce ss program still provides a lot of opportunity.

Just a reminder, in the US, what that program is is the government had one program that first started out with a limit on loan to value that you could refinance. This program really allows every bank to refinance every other bank's customer with a backstop -- a government backstop on unlimited loan to value. So, it really gives an opportunity to everybody in the market to be able to refinance customers into lower payments and have some insurance on the fact that you're over market on the value. I think the market will continue to be strong, and even though we -- probably a couple months ago we saw projections that had some concerns about volume declines. Next year MBA still thinks it's about 25% down. Volumes are still pretty strong, so until we see some dramatic change, I'd say I would expect to see good volume and a little more purchase next year, maybe a lot more purchase, and that would be good for everybody.

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

Thank you.

Operator

Thank you. The following question is from Sumit Malhotra of Macquarie Capital Management. Please go ahead.

Sumit Malhotra ***- Macquarie Securities - Analyst***

Good afternoon. First question is for Tom Flynn. It's on your Basel III common equity ratio. If I look at the numbers you've given us this year, from Q1 to Q2 you had a 40 basis point increase from 7.2 to 7.6. Something larger this quarter in the neighborhood of 70 basis points. If I look at the sequential change under Basel II RWA, doesn't look like there's too much of a difference between the two quarters, so I'm hoping you can help me understand why the larger magnitude of increase this time around.

Tom Flynn - EVP & CFO - BMO Financial Group

Sure so maybe I'll do that by just walking through the big components of the change in the Basel III ratio, Q2 to Q3 and the ratio went from 7.6 to 8.3 as you said. The biggest single driver was retained earnings growth, and that added about 20 basis points to the ratio. Common shares issued through the DRIP and for options added about 8 basis points to the ratio. There's a deduction from capital related to expected losses in excess of allowances, and that improved this quarter and added about 8 basis points to the ratio. And then there was another 20 to 25 basis points that resulted from changes that were made in some of the deductions from capital that you have with the Basel III ratio. And there, there was some refinements in the approach that we're taking to the calculation and some changes in facts as well and together, they drove that change. So, those are the big items quarter over quarter. The change this quarter, as you point out, is bigger than we would expect in the ordinary course and we're pleased to see that. But going forward, we expect the ratio to trend up, but not by close to a like amount quarter to quarter.

Sumit Malhotra ***- Macquarie Securities - Analyst***

So, the meat comes from the, if I can call it that, comes from the refinement that you talked about this quarter 20 to 25 basis points. I think that's the additional difference. And I know this is a fluid process in terms of some of the changes that are coming through, but anything specific you can point to there that you adjusted, or should I just take your comments that this is something we're unlikely to see repeated going forward?

Tom Flynn - EVP & CFO - BMO Financial Group

Well, I guess a couple comments. We are going through a process with the industry to move to Basel III. There is greater clarity being provided around some of the details of the rules through time, and OSFI clarified some issues this quarter which was helpful. And so I'd take this as sort of moving towards finalizing the ratio as we head into '13.

Sumit Malhotra - ***Macquarie Securities - Analyst***

All right, I appreciate that. Let me head over to Frank for a second. Frank, you've mentioned a couple times in your commentary around net interest margin in the past few quarters that one of the factors leading to the compression has been loan growth faster than deposit growth. Also, if I think about your tenure as Head of P&C Canada, relatively early in that time you opted to strengthen the focus around the branch channel as BMO's primary origination point. If I kind of combine those two things, what would be your interest level in pursuing a deposit based acquisition in Canada, especially if it involved a channel that was outside of your now very focused -- very much focused on the branch channel?

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

Well, I would say that we're always interested in looking at acquisitions that would be attractive to us, whether that would be properties that were strong in deposits or strong in loans. We've continued to look over the last few years and we'll continue to look going forward to build on our franchise.

Sumit Malhotra - ***Macquarie Securities - Analyst***

I don't think I phrased that well, so let me get more to the point. Would you be interested in a property that you had to run separate from a Bank of Montreal branch product?

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

Well I think I'll just stick to my answer on that one. Relative to our strategy and our focus on our brand promise, that is the key for us. We think we're different from our competitors. Our brand promise is one that we're going to continue to promote. The channels that we continue to build on are important to us today, and they will be important to us going forward.

Sumit Malhotra - ***Macquarie Securities - Analyst***

Thanks for your time.

Operator

Thank you. The following question is from Robert Sedran of CIBC.

Robert Sedran - ***CIBC World Markets - Analyst***

Hi good afternoon. Frank, I don't mean to keep going back to this retail margin. You actually have provided a lot of very good information. I have a bit of a philosophical question for you. Because you've mentioned competitive pressure, and I think everyone is feeling it. Do you get to a point where you need to have a pricing response to protect the NIM? I know the goal is to grow revenue and not margin. Or are you just focused on volume growth and business growth and then NIM is going to go where it goes?

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

I think at this point in time, Rob, we're still viewing the market as being balanced. I've said this in the past. Volume growth is important for us going forward, and stronger volume growth is important for us going forward. I think at least for a while the margin is going to go where it's going to go, and we're all doing our best to manage that. And in this quarter, we had a fantastic quarter from a balance sheet growth perspective. Personal loans were up 6%, commercial loans were up 6%, that was the strongest growth that we saw in the past five quarters. And our market share was strong across all our retail products as well, so we really have been working hard on getting more than our fair share. It came through this quarter and my expectation is we're going to continue to compete hard.

Robert Sedran - ***CIBC World Markets - Analyst***

Okay, thank you and Tom, just to follow-up on the insurance business. I'm trying to understand if the charge taken this quarter is just from the intra-quarter impact of lower rates in this specific period or whether there's some impact from the falling ultimate reinvestment rate that you had to take in the quarter.

Tom Flynn - EVP & CFO - BMO Financial Group

The charge this quarter was a bit of both. The ultimate reinvestment rate is impacted by what happens to rates in the quarter although the calculation is different, as you know, and that part of the charge was around 15% to 20% of the total.

Robert Sedran - ***CIBC World Markets - Analyst***

And do you take that URR charge? Do you do it quarterly or is there an annual adjustment to that?

Tom Flynn - EVP & CFO - BMO Financial Group

You do it basically as required when long term rates change by in excess of a threshold level.

Robert Sedran - ***CIBC World Markets - Analyst***

Okay, so you do evaluate it quarterly then?

Tom Flynn - EVP & CFO - BMO Financial Group

Correct.

Robert Sedran - ***CIBC World Markets - Analyst***

Okay, thank you.

Operator

Thank you. The following question is from Mario Mendonca of Canaccord Genuity. Please go ahead.

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

A quick numbers question first. Could you tell us what contribution M&I made to -- specifically to the US P&C segment? That's my first question.

Tom Flynn - EVP & CFO - BMO Financial Group

It's Tom. The contribution this quarter to the adjusted income was $77 million.

Mario Mendonca - *Canaccord Genuity - Analyst*

Okay, that's helpful, and then Surjit, could you go back to one of your opening remarks. You said the timing of recoveries, and I think you said the impaired acquired portfolio may not match up with when you take the credit losses. First if you could just go through that statement one more time?

Surjit Rajpal - EVP & CRO - BMO Financial Group

Yes, that comment was more with regards to the purchased performing portfolio. In the purchased performing portfolio, when we acquired the portfolio, you look at it and you have a good sense of it and it becomes like any other portfolio that you own. You bring it back on your books and you run it like one on your books, so you really can't predict the timing of the losses on that portfolio. So, the comment I was making was that if you look at it on a quarter over quarter basis, the results, the last few quarters were really good. We had, I think the number was $44 million last quarter and this quarter it's $113 million, and the point I was making was, look, quarter to quarter it will vary. In some ways, when you look at it you've got to look at it more on the basis of it being a portfolio that you look at on a cumulative basis over a period of time.

Now in these quarterly calls we focus on just the quarter. This quarter it's high, last quarter it was low, and the quarter before that it was also low. So, what I was saying was that the timing is difficult to predict. The second comment I was making with respect to timing was that we do take the amortization of the credit mark as well as the repayments into income through NII. And for example, in this particular quarter, we've taken this $113 million loss that we've taken is more than covered by the amount we've taken into NII, which is $212 million, if I remember right, $212 million, and that was the other timing difference that I was talking about.

Mario Mendonca - *Canaccord Genuity - Analyst*

So, the message -- and this was all with reference to the performing portfolio, the stuff that you treat as an item of note?

Surjit Rajpal - EVP & CRO - BMO Financial Group

That's correct, and the other thing I'd like to point out is all of these adjustments that we make in this portfolio we run through corporate. This is not something that we put through the business.

Mario Mendonca - *Canaccord Genuity - Analyst*

Sure, and so I guess the quick message then is just simply that these items of note could also go the other way. It's not always -- is that the sort of the short and sweet conclusion to this?

Surjit Rajpal - EVP & CRO - BMO Financial Group

Yes, they could go either way.

Mario Mendonca - *Canaccord Genuity - Analyst*

Okay, and then just finally for Frank again, going back to the domestic margin, and sorry for this, after everything you've offered us, and a lot of it was very detailed, what is your outlook for the domestic margin going forward?

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

Yes, thanks, Mario. Based on our balance sheet growth aspirations and a similar interest rate environment, I'd expect to see margin compression to continue for the next few quarters but at a level lower than we saw this quarter. More in line with the average quarterly decline over the last four quarters.

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

So, 2's and 3's rather than the 7's and 8's? Is that fair?

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

I've got myself into trouble last quarter being precise, so I'll stick with what I said.

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

Yes, I don't blame you, thank you.

Operator

Thank you. The following question is from Andre Hardy of RBC Capital. Please go ahead.

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

Thank you. This is for Surjit. You disclosed that you have $4.9 billion in loans to the agriculture sector. Can you help us understand what's in there, what's affected or not by this summer's weather conditions and in the end, what in there keeps you up at night relative to the very difficult conditions many farmers have faced?

Surjit Rajpal - EVP & CRO - BMO Financial Group

Well, let me start out. The portfolio that we have is both in Canada and the US. The part of the portfolio that is being impacted by the current drought conditions in the Midwest is mainly in the US, and I would say that some sub sectors are impacted more than others.

The three sub sectors that are impacted, let me at the outset say I think we're very comfortable with our portfolio, but the three sectors that I'm loo king at more closely are the sectors which encompass grain, protein, and dairy. And o ur exposure to these se ctors is not of a size that I am worri ed about or should be concerned about but nonetheless, these are the sectors that get impacted more immediately. And the grain sector is the one that has the most immediate and direct impact. Now having said that, the grain sector has the farmers and the farmers for most part have insurance, and so they will be b enefiting from the insurance payments that they re ceive. And even though their yields are low, prices are high, so that is also some what offsetting it. As you know, we've announced a relief program for those farmers in need to tide them over the growing cycle right up to next year if necessary. So, that's a sector we worry about, but really, I think in the short-term, unless there are multiple years of drought, one shouldn't be concerned.

The other two se ctors, protein and dairy have somewhat similar characteristics. The cost of inputs go up and to some extent, a lot of these companies do have short-term hedging, and will perhaps have to absorb some of it for a bit before they are able to pass it o n to the cons umer. The prevailing wisd om is that most of these thing s get passed on to the ultimate consumer, so that's what I would say. Then the fourth sector which one should worry about is ethanol, where we hardly have any exposure whatsoever. All in all, I'd say we'r e very comfortable with what our exposure is and the risk profile of it.

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

Just two foll ow-ups. Are you willing to clarify the size of these sectors, and if not that's fine, but you say you'd h ave to worry if the drought lasted for m any years. Or is that your m essage here is that o ne year is not enough to ca use problems? You would need two or three years before you'd see losses in your book?

Surjit Rajpal - EVP & CRO - BMO Financial Group

That is correct, and that gives you time to readjust. When you get into this sector, you are accustomed to these short-term blips, and I don't think one or two years does it at all because there is resilience right now and I'm not concerned. In terms of size, I can give you some size. These portfolios of concern would be less than $2 billion.

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

Thank you, Surjit.

Operator

Thank you. The following question is from Brad Smith of Stonecap Securities.

Brad Smith ***- Stonecap Securities Inc. - Analyst***

Great, thanks very much. Given that this marks the fourth quarter of operating the M&I business down in the US, I was wondering if we could just revisit for a moment the integration cost profile, if you could just summarize for me the total costs that have been spent on the integration. I think the last estimate was, $600 million was the total, so we can see where we're at there. Maybe comment on where you expect the final integration expense to come in. And then second question, if we could just recap what the return on your investment, what the investment was and what the return has been over the last four quarters.

Bill Downe - President & CEO, BMO Financial Group

Brad, I'm going to give Tom a minute just to turnover a piece of paper with the specific numbers. The one-time costs that we're incurring are on track with the revised numbers that we have provided, and he will give you a little bit of a reminder. I think there's actually a press release disclosure on that as well.

Tom Flynn - EVP & CFO - BMO Financial Group

It's Tom, Brad. I'll give you a bit of a response and if you want to follow-up offline, we can do that. We haven't had a detailed update on the one-time costs for a couple of quarters, and that's because not much has changed in terms of our expectations for what the costs will be. We're showing the costs in our schedule that shows the adjusting items every quarter, so you can see them build up, and we're sort of on track in terms of how the expenses are coming in. In terms of the contribution that we've had from M&I since the close, I'd say we continue to feel very good about the acquisition. The businesses have come together in a really good fashion under Mark's leadership. We've got a lot of alignment around the approach we're taking to the business, and the income contribution has exceeded our business case and the credit performance has been better than planned. The contribution to the income year-to-date, so for the first three quarters is about $560 million to the adjusted income and as it happens, basically the same number to the reported income. The reported number is $557 million for three quarters. That's a recap of how we're feeling and where we sit and we can follow-up with more detail of you'd like offline.

Brad Smith ***- Stonecap Securities Inc. - Analyst***

Okay, Tom, just a couple of things though in terms of specifics. The amount of capital that's invested in the US entity, like in Harris National Association, the regulated bank down there, I believe its been about $12.6 billion over the last four quarters on average, and so I'm just wondering how we should look at that from a rate of return. The regulatory return is about 5.6%, so is the return to the consolidated bank higher than that?

Tom Flynn - EVP & CFO - BMO Financial Group

We talked about this at our Investor Day in the US, and we expressed confidence that the returns in the US business would be above our cost of capital. We've got growth plans for the business and synergies that are going to come in, and you can't totally compare the numbers that you see from the US regulated entity to the consolidated BMO results. They're directionally similar, but as we've talked about before, not directly comparable.

Brad Smith - *Stonecap Securities Inc. - Analyst*

But when we talk about the synergies, I believe that the way you were accounting it, those synergies are reflected in your contribution numbers, your adjusted contribution numbers to get you to the $561 million?

Tom Flynn - EVP & CFO - BMO Financial Group

That's correct.

Brad Smith - *Stonecap Securities Inc. - Analyst*

Okay, so my curiosity here is that the progression on those contributions is Q4 $149 million, Q1 $215 million, Q2 $181 million, Q3 $165 million, seems to be dropping. Is there a reason for that?

Tom Flynn - EVP & CFO - BMO Financial Group

The adjusted income reflects the operating income that we've got in the groups and also the recoveries on the credit impaired loans that Surjit talked about and those numbers move around quarter over quarter. The operating income at the group level is down a bit, and that reflects lower loan balances in some of the portfolios. And some of that reflects the effort that we have underway to reduce the commercial real estate portfolio which we talked about at the time that the acquisition was announced.

Brad Smith - *Stonecap Securities Inc. - Analyst*

But bottom line, the 15% IRR target remains intact?

Tom Flynn - EVP & CFO - BMO Financial Group

We feel good about where we sit today compared to the assumptions that were in place when we announced the deal. And as we talked about when we announced the transaction, the IRR number reflects the benefit of the business growth through time and also some capital relief that will result from working off the higher risk parts of the portfolio which are quite capital intensive.

Brad Smith - *Stonecap Securities Inc. - Analyst*

Thanks, Tom.

Operator

The final question will be from Steve Theriault of Bank of America Merrill Lynch. Please go ahead.

Steve Theriault ***- BofA Merrill Lynch - Analyst***

Thanks very much. A couple of things. First for Tom, can you just quickly refresh us on what you view as a sustainable tax rate? And then for Frank, Frank, I was going to ask you a question on margin, but I'll spare you that after the barrage, but I would like to ask about expenses. With the negative operating leverage this quarter, can you refresh us on your outlo ok for expenses? Do you think you're still in a position to report positive operating leverage for 2012? And I ask that because it looks -- to me it looks doable with respect to the math if you have a strong Q4 on the expense side, but I often think of Q4 as a tough expense quarter, so I'd be interested your thoughts there.

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

Okay, Steve, I'll go first. Yes, with expenses, I think it's going to be a coin toss as we go down through the end of the year. Obviously, our Q1 put us a little bit in the hole and so we've been trying to climb out. I think it's going to be tough to get to positive for the full year. I t hink what I said la st quarter was we were working hard for a positive number for the second half of the year, and so we'll see how we do.

We're managing our operating expenses tightly. Ob viously, we've got not a lot of expense gro wth year over yea r. Our headcount is down p retty dramatically year over year, but we're continuing to invest in the business, and I just want to make that clear. We still fe el strongly about some of the things tha t we've chosen to invest in and are ke y for our future competitive success and we're going to continue to do that collectively as we go through the next few quarters.

Tom Flynn - EVP & CFO - BMO Financial Group

And then on the tax rate, we thin k the most relev ant effective tax rate to look at is the djusted number, and that's because the reported number gets uninfluenced by some items that aren't subject to tax. The tax rate was low this quarter compared to where it's been on average over the last four or five quarters, but if you'd look at the last five quarters, we've been below 20%, three of the five quarters a nd a little above two of the five, and the avera ge of the last five quarters is right around 20%. Looking ahead for the next few quarters, we'd expect to be in sort of th e 20% to lo w 20%s kind of a range.

Steve Theriault ***- BofA Merrill Lynch - Analyst***

That's on a TEB basis you're talking?

Tom Flynn - EVP & CFO - BMO Financial Group

That's correct. [sic]

Steve Theriault ***- BofA Merrill Lynch - Analyst***

Thanks for taking my questions.

Sharon Haward-Laird - Head of IR - BMO Financial Group

Thank you, everyone, for joining u s today. If you ha ve any further que stions, we would be pleased to take them if you contact the Investor Relations team. Thank you.