Bank of Montreal at the 2024 RBC Capital Markets Global Financial Institutions Conference

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PRESENTATION

Darko Mihelic – *RBC Capital Markets*

We're going to start our next session with the Bank of Montreal. I'm delighted to have you Piyush Agrawal here, the Chief Risk Officer for BMO. Piyush, welcome to the conference.

Piyush Agrawal – *CRO – Bank of Montreal*

Thanks for having us. Good morning, everybody.

QUESTIONS AND ANSWERS

Darko Mihelic – *RBC Capital Markets*

A unique opportunity here with Piyush up on the stage. You have a bit of a background in working in risk in the U.S. and now for a Canadian bank, and we do have a little bit of a different accounting approach and sometimes we see some things happening, so I thought maybe we can just kick off with a quick question on how do you see it, now that you're working for a Canadian bank, the difference is in terms of IFRS 9 versus CECL accounting. Then we'll dovetail that into what we saw in the just recent quarter with a performing loan loss build. Over to you if you can just give us a brief tour of how you see it and we'll walk through why Bank of Montreal built reserves in Q1.

Piyush Agrawal – *Bank of Montreal - CRO*

It's a little bit of a technical question and I'll try and simplify it for our investor base. IFRS 9 and CECL are very close cousins because, at the end of the day, they are the methodology of how you get into your provisions. And it's obviously supported by hundreds of pages of literature and guidance by the different regulators who look at it.

But very simplistically put, the biggest difference between IFRS 9 and CECL is the duration of the portfolios and how long you reserve for. So under CECL, you take lifetime losses. If you've got a 5-year duration, you probably see something which is 5 years in length. Whether you're performing or whether you have a credit weakness or whether you're in default, you just have to look at the entire lifetime.

In IFRS 9, there's a dual treatment. For the current book, it's a 1-year loss, but then when you start seeing changes in credit deterioration, Stage 2 or Stage 3 is when you move from 1-year to lifetime. For any book, you'll have about 94% in Stage 1, 5% probably Stage 2 and 1% Stage 3. And the difference then becomes for that 94%, you're booking a 1-year timeline, as compared to CECL you're booking a lifetime.

Canadian banks, BMO included, you see our allowance coverage as a blend of the Stage 1, Stage 2, Stage 3 at around 55 to 60 basis points for the bank's performing coverage. If you were to take our U.S. peers, given the duration of the book, you would see 3x to 4x higher coverage. Now here's the interesting part. For us at BMO, we apply IFRS 9 for our enterprise, but we also have a significant presence in the U.S. and we comply with CECL in the U.S. And so our U.S. coverage is in line with U.S. peers in the 3 to 4x Canadian bank peer coverage.

To give you an example, Canadian mortgages are 3 to 5 years. We take a 1-year loss as long as they're performing, and as you know well, most of them are performing in Canada. But in the U.S., where mortgages are longer in nature contractually, 15 years or 30 years, you're holding a lot more provision.

The fun part is, for us and probably our peers, we use exactly the same models. We use exactly the same scenarios. The biggest difference out there comes into the duration and then those have its advantages and disadvantages in terms of what the regulator has in their intent of do you want to lend more or lend less because you're reserving so much more under CECL. Then there's volatility aspects depending on how CECL might work or IFRS 9 might work.
It's really the coverage difference based on duration of the book, lifetime versus 1 year.

Darko Mihelic – *RBC Capital Markets*

That's a really good compact answer, so now we can talk about the trends that you're seeing and talk about sort of what we saw in the first quarter and one of the things you saw in the quarter wasn't a massive build of reserves, but it was bigger than peers. So over to you and a discussion on what you're seeing.

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, the provision process is a quarterly process, high in governance internally because it's such a big element of any bank in what we do and what we signal.
If I just want to break it down simplistically because both CECL and IFRS 9 are very forward-looking, it's really based on a couple of forward-looking scenarios that you have to take in. And so we begin with where BMO economics for us projects out what the base case might be or what an adverse case might be and you take a mix of those and you put weights around it. And I think our investors would probably appreciate that the economy is getting better, so our macroeconomic scenarios going out are better than they were in the previous quarters. We've averted a recession in the soft landing, but things are getting better. That's a big element of how you think of the forward scenarios.

Then you've got portfolio size, portfolio quality. Sizes, we have sort of grown a bit, it's flattish, so that wasn't a big driver. And so portfolio quality becomes then a very big driver, especially for us in Q1. I can break it down into more detail, but just at a very high level there is softness, as you're seeing, in the unsecured portfolios.

As the transmission of the entire rate cycle and the hike of 5%, consumers haven't fully absorbed it. They are still absorbing it and you can see that in data in delinquencies, whether it's in cards and unsecured loans. We're not seeing it in secured mortgages, and I know it's a big topical discussion. We've spent time in the past, we can talk about that again. That's doing very well.

Similarly, on the wholesale side, commercial customers are feeling the pain of both inflation and higher interest rates. Anybody who postponed decisions thinking rates will come down, it's a year later, rates are still high up and it just eats into operating cash flow, which then reflects into risk rate. Credit migration has been a big piece, and about half of our performing build was on account of credit migration, which has been happening and we've been building provisions for the last one year.

There was a second component to it. The second component just very quickly is, as many of you know, we had a very successful integration of Bank of the West out in California. It's a $100 billion bank that came in, and as we integrated Bank of the West and all the models of Bank of the West within the broader Bank of Montreal, you don't want to lose the richness of data that now comes in also with Bank of the West.

Model refreshes are an ongoing feature. You don't see it in a big way. One time, we took that data, we brought that in. It gives you much more visibility of default rates or recovery rates over different environments. As we upgraded the models, what we were doing through credit judgment all along a little bit of what things might be in the future, now it's flowing into the model, so half of that was the model.

The way I sort of bring this together is the environment is still soft. We've all agreed on that. There is going to be continued softness as we'll see more deterioration on unsecured. I look at the outcome of where are we on the coverage and our coverage was 54 basis points from a performing allowance last quarter and we're at 55 basis points. We're not off at all, in fact, it gives me great comfort that from a prudence perspective, we're in the mid-50s coverage on overall performing allowance. So yes, a slight build, but I think going into the environment we are, it's good to be where we are. And then we'll see how the environment unfolds and our portfolios react to those environments in the future.

Darko Mihelic – *RBC Capital Markets*

And so when we think about the richness of data that you just pulled in from Bank of the West, seems to me like it's a one-off. Could there be other model refinements that have to happen from here on in, or is this really just a one-off and we should really think more about a performing build that's more in line with, let's say, half of what you just said?

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, this is truly one-off. I don't expect this to happen. I joked on the call until you see our next M&A. When we get the next set of data, we'll do it again. I don't see that. There are many models underlying so many of these calculations, those get updated. Every year, we get new data of our own default rate, so those get updated, but those I don't expect to be major shifts. So yes, don't expect model updates going forward anytime soon in this quarter of that magnitude.

It's really going to be now our impetus on portfolio growth. We're beginning to see some growth come through. We'll see how macroeconomic shifts. We've talked about in our assumptions we expect rate cuts in the second half of the year. Those are embedded in our assumptions. That trajectory is not linear and market is betting a little bit now softer on the rate cuts and the timing of those. So those will change. At the end of the day, even with rate cuts, how that will impact credit is going to be something that we continue to watch. Credit migration, credit growth, both of those will be big going forward.

Darko Mihelic – *RBC Capital Markets*

Maybe we can just turn our attention to impaired. Maybe you can talk a little bit about the trends you're seeing in the impaired portfolio and what we specifically saw more recently and what you're thinking about in the next couple of quarters?

Piyush Agrawal – *Bank of Montreal - CRO*

The impaired portfolio, I'd say, this is a classic credit cycle. I haven't been surprised by our impaired trends. In fact, if you think about our long-term averages, we've outperformed our peer group and our long-term impaired loss rates we've said is in the mid-30s averages and they're obviously despite bad times. We had an impaired loss performance of about 29 basis points this quarter, which I have indicated or signaled that we expect '24 to be in the low 30s. They will trend up a bit but overall, I think with some intra-quarter volatility or variability, I feel pretty good about that.

And the reason I think the 29 basis points, low 30s, is our visibility on impaireds for the type of lending we do and the risk culture we have give me confidence, and I'll just explain that in a second. Impaireds don't show up from performing to impaired overnight, right? You have a trend where you start to see delinquencies come through the pipe. If it's unsecured or secured, somebody is 30 days delinquent. Their roll rates going to 60, 90 and so on, so you've got a pretty good handle on what's going on in the underlying portfolio and how much of that might flow into impaireds. It's the same thing for even the wholesale side. It's ratings and migrations. We would be shocked if I saw somebody go down 5 or 6 notches in a risk rating overnight. It's a very slow trajectory and we continue to work with clients, see where the challenges are so you can tell how much is going down. It's going to be in watch list from watch list into an impaired formation.

When we look at the impaired formation and look at our history of data of how much of the formation really becomes a loss, we get pretty good ranges to signal where impaireds might be. There'll be idiosyncratic losses. That's always the case that it might be a fraud event or so. We haven't seen that, but that's why I feel much better about providing impaired guidance on the quality of the book and the migration we've seen and that's why the low 30s.

Darko Mihelic – *RBC Capital Markets*

And so picking up on that, maybe we can just drill down into some of the portfolios and talk maybe more specifics. You mentioned earlier, there's been a lot of attention on Canadian mortgages. I've been pretty involved with the space myself. One of the things that we continue to look at and think about with the Canadian mortgage portfolio is this renewal schedule that we can all see, then I'll calculate how much of an increase we're seeing in mortgage payments.

We are starting to see some increases in delinquency so maybe you can walk through some of the trends that you're seeing there and why they're not translating into loss and why they may not translate into loss.

Piyush Agrawal – *Bank of Montreal - CRO*

Our book is about $150 billion of mortgages and in the peculiarity of the market, there's obviously a variable rate mortgage 3 to 5 years, we have a fixed payment that results in negative amortization and that's why the reset of the negative amortization every 3, 5 years results in what, Darko, you're referring to as the payment pickup. You're beginning to see that payment hike in the renewal. We've seen about 20% to 25% depending on a fixed rate or variable rate because both of them are going through the higher rate environment.

The anecdotal data, which I've talked about, we've had about $18 billion to $19 billion of resets in the last 4 or 5 quarters. The payment performance at the higher rate is much better than those that are still continuing. Again, it's a low-delinquency portfolio, but I'm just giving you a sense that there is something about the Canadian consumer and the Canadian mortgage that has a very tight correlation of good payment performance.

You're seeing now, on the other side, choices being made by Canadian consumers on cards so we get daily data on card spend. We know exactly where money is being spent, and you can see discretionary items, T&E, travel effect come down, grocery go up. You'll see a little bit uptick in the revolving, right? People are revolving a bit more to pay cash, pay out the mortgages.

While the delinquencies have moved up a bit, I'm not concerned really because some of it is administrative. Even in the neg am book, we've now got digital tools that are more friction-free for consumers so almost 50% of our variable rate neg am book has taken some action. Our neg am book was larger in size, and I think almost $17 billion reduction in the total neg am came in the last 1 or 2 quarters alone by just people taking action and either topping up payments or resetting the payments. It's a huge positive.

The last one I'll make is there's still extra cash in consumers' accounts from COVID, it's come down. It's just extra cash. FICO scores remained high, 790, 795. Even on the way down, and we stress test this all the time, even if there's inflation in FICO by a few points, it takes time to catch up. Even at the lower FICO, it's still a very healthy book.

The best part is there is equity in the houses. The LTV is about 50%, 55%, you can stress test at 5%, 10%, 15%. You saw the data today or yesterday. Vancouver is up, Toronto is up in HPI. Even though our HPI, base case there might be a slight decline, there is enough equity. The value or your net wealth is invested in your house, it's the last thing you want to walk away from and there's no substitute. There's no housing available for folks, so folks are really embedded into that housing as their asset class, putting more money in.

I think the rate cycle is going to now be the big driver of seeing some of that softness come down. It will take some time. Even if rate cycles came down, the transmission will take some time, so that's why I feel very good about our Canadian mortgage portfolio. We've stress tested it in many different ways. We've looked at international markets to see what's happened there, but there's something very unique and very precious about our Canadian mortgage market that seems to be doing very well

Darko Mihelic – *RBC Capital Markets*

And everybody is working.

Piyush Agrawal – *Bank of Montreal - CRO*

And everybody is working. Look at unemployment, right? We just talked about unemployment before. Unemployment has been surprisingly low, and even though we think it can go up, there are yet businesses looking for employees. There's still a shortage of employees everywhere, both here in the U.S. especially, but even in Canada.

Darko Mihelic – *RBC Capital Markets*

With that discussion on the mortgage book, maybe we can talk a little bit more about the commercial side. BMO is known to be much more involved on the commercial side. Maybe we can get very specific because we've had some discussions during this conference about commercial real estate. You do have a portfolio of commercial real estate, some office, some in the U.S. Maybe you can size it for us. And recently, one of your peers basically said, you know what, we're substantially past the issues of commercial real estate. Can you say that today?

Piyush Agrawal – *Bank of Montreal - CRO*

I think a risk officer should never say that, so I won't say we have passed all the issues. What I would tell you is the number one rule for risk management really is concentration, right? As long as you stick to your limits and the culture of underwriting, which has stood the test of time, that's what's going to be the winning formula at the end.

For us at BMO, our total CRE, we've said, commercial real estate, is about $65 billion to $70 billion. It's about 10% of our total lending book, so that's a good lower number to be. I don't feel we are overly concentrated. But then commercial real estate, as many of you know, is not one asset class. It's a combination of multiple asset classes. I'll take office. Office is about $7 billion, so that's another 1% of the total book for lending, 14% of CRE. I'll break office up then into suburban, urban, medical facilities. Medical facilities you can't get enough of. There's more demand right now and there's actually more transactions happening there, so doctors' offices and medical facilities are full up.

In these, what we've done is we've looked at each of our large properties and re-underwritten them in the last 18 months. When we re-underwrite them, there's a parallel team that stress tests the hell out of them by saying what happens if vacancy rates go down another 30%, 40%, what happens if cap rates move, what happens if interest rates move? We already identified in this $7 billion cohort minus medical, minus some of the suburban to see where are the challenges. I'll tell you I can count those properties that we've been watching on my fingers in terms of where we see potential stress.

Now through the last six quarters, you may not have noticed, but we've taken very minute sized losses already in some of those through that stress mechanism in the impairment, but we've also reserved in a performing provision for those areas where we feel there could be potential stress. So I feel pretty good looking back at all of the actions we've done. If our allowance coverage today of 55 basis points for the entire book, I would say, for CRE, we are over 2x, for office, there are probably a couple of multiples of that provisioned already for office. And so I don't expect any surprises. Our workout team and our bankers are working with some of the borrowers. These are relationships that are not a one-off relationship, 30, 40 years. From that perspective, I feel like it's a very small, contained problem, if it is.

We're not in areas that are hurting. I mean, even though we've got a portfolio from Bank of the West, San Francisco has been in the news. It's not the city alone that matters, it's the type of property you're in. And we've seen two Class A properties in the same city can behave very differently. Forget if you're a Class B or a Class C, and I think those are the things that we are seeing.

Are we out of the woods? Is the industry out of the woods? No, there's more to come but now in addition to that, you're seeing a revival of interest from players who are saying, I think value is a bit beaten up, I'm ready to get back in the market. You're getting interest from private equity, you're getting interest from buyers who think that there's a steady IRR in this. Work habits are changing. People are coming back to office. I think that's a positive thing. I think to the end of '24, you should see much more of this even out and we'll find a new equilibrium where we are.

Darko Mihelic – *RBC Capital Markets*

And multifamily has made a little bit of noise recently and maybe we can talk a little bit about...

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, we have multifamily. It's about 1/3 of our total CRE book. I want to say over 2/3 or at least over half is investment-grade. We're sitting here in New York, I'll tell you, this is a place where rent control was a big deal that played out for some of our peers, and we're not in any of those. We began looking at our multifamily. More than half is in Canada. Canada, as you know, vacancy rates are very low and so there's no challenges that we're seeing in Canada.

In the U.S., there's probably a little bit of oversupply, overbuild in the Southeast, but we've gone through and looked at any names that have a lower debt service coverage, any names that are large in size, any names that have geographic concentration, any names that have rent control attached to them. None of that has filtered up right now as something as a problem. We continue to review them. If more is needed to be done, we'll do it but at the moment, I can tell you that I don't see any concern in our portfolio that's imminent around multifamily. It's the rent control areas and those are very, very limited in our portfolio.

Darko Mihelic – *RBC Capital Markets*

Is it a situation where maybe it's different from the office space in terms of reserves? Are you as adequately reserved there as you'll be the office-based portfolio?

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, because we haven't seen any problems at our multifamily, CRE overall is 2x, so you've got already higher coverage for multifamily built in. Office has, and I said, significantly more coverage built in. If it's needed, we'll take the actions, but I don't see multifamily getting to the same kinds of news items or trouble barring some pockets. Again, like I said, New York, because the rent control was in the news, we don't have any exposure in New York.

Darko Mihelic – *RBC Capital Markets*

Okay. I'm going to pause here and see if there's any other follow-up questions on that line of questioning or any other question for Piyush before I continue my questions. If you have a question, please raise your hand.

With the questions out of the way, one thing that's sort of interesting to me is when you closed the Bank of West transaction, it brought more consumers in California. Maybe you can just talk about that dynamic, I mean, obviously, we just saw the whole influx of data come in and hit the performing.

Other than that, I'm wondering just how that changes, if at all, how you view growth prospects, and in general, how you view that? I mean, I guess you're not really tracking any differences anymore and you kind of run the bank north-south, right? I'm curious just to see what you can tell me.

Piyush Agrawal – *Bank of Montreal – CRO*

Number one, overarching strategically, if you think about it, California, as one of the largest economies in the U.S. or in the world now, gives us a footprint that we were missing and now it's part of the BMO angle, so we are very excited. You can't have strong U.S. GDP growth if we didn't have strong California growth, right? There's an embedded setup there, and both our consumer and commercial footprint now in California have been very impressive. You've heard Darryl and Tayfun talk about expense synergies, we are probably ahead of that, and the PPPT that we will get.

From a portfolio perspective, we've been very pleased. I think it's exactly in line with our BMO U.S. footprint. The important aspect of any of these acquisitions comes down to the people and the culture. I was last week in California with our legacy Bank of the West, now BMO, team, there's a huge amount of excitement. I mean, I think you're seeing both on the revenue side higher productivity, but just on the portfolio management side, the integration that's been pretty world-class.

I can tell you sitting up in Toronto or wherever else what we are doing in California in any given day. We had inherited a very good RV book. That business continues. Even though we did a transaction, we are top three and we plan to be top three. Our originations coming in right now through the door are very high quality.

Overall, I'm very pleased with the performance of the book that we've inherited. We are growing it now similar to what we're growing anywhere else in the U.S., similar to what we are seeing in Canada, but the U.S., growth is rather different, better growth right now than Canada. Having Bank of the West with us is actually a helpful feature because we're now embedded into the California growth and the portfolios are doing pretty well.

Darko Mihelic – *RBC Capital Markets*

You mentioned the RV portfolio sale. It's also something else you've been doing. Just curious, as a CRO, when you put the indirect auto into runoff, we saw some losses in the quarter. I think now you're booking them into corporate. How should we think about that progression from here now that it's in runoff?

Piyush Agrawal – *Bank of Montreal - CRO*

I thought it was a very good proactive action on our part because one of the things we've always wanted to do is to be cross-selling to other consumers or customers. I think indirect auto, as you see, benefited during COVID. A little bit of that benefit of COVID when there were cars in short supply and people going in to buy anything you could during that time is playing out now. As an industry, autos are seeing delinquencies increase, especially in the second half.

It's been a good business, but not core to what we want to do with our capital allocation. We've taken some of those losses through the corporate sector. I don't think that's going to continue for a long period of time. The book is becoming smaller. Things will get paid off. Any book in liquidation, you'll see a little bit higher losses, but as a percentage of the overall BMO, I think it's a rounding error. I wouldn't worry about the indirect auto from that perspective. We obviously continue to report on that. We manage that because the book is still ours, but yes, everything else is tracking to what our risk appetite has been.

Darko Mihelic – *RBC Capital Markets*

We've only got a few minutes left here, so let me just dive into the risk transfers that have been pretty topical, got a lot of air time in the conference call. Maybe you can just give us an overview of how involved you are in these transactions and BMO seems to say that we do these transactions so we can grow, right? Is there a limit to how many of these transactions? Are we reaching that limit? Maybe you can talk a little bit about how we should think about this going forward, and should we see less of this activity or more or about the same?

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, so if you go back in time and how we began, this is not new to BMO. BMO has been doing this for many years. It ramped up, and it ramped up really because of getting ready for a very large acquisition. But it doesn't only have capital ramifications, it's also a risk management trade that helps significantly. When you think about loans on the book, we don't tell our bankers what loan is going to get put into an SRT or synthetic risk transfer. We book to originate and hold the loans. The quality, therefore, is never diluted because something might be in SRT. So that's a very important consideration.

The second piece is there are various risk-mitigation activities available to us. The synthetic risk transfers, given the liquidity in the market, given the strength of BMO's risk understanding through our investor lens was a very attractive mutual, I'd say, meeting of the minds where they came in and we put things into the risk transfer bucket. They are both capital enhancing, so the RWA benefit that you get can be significant. The provision benefit that you can get from SRTs can be significant. In fact, last quarter, we actually had a benefit even with our impairment, for some names that are in an impairment, you basically get full protection for those names. I do want to tell you there isn't any counter-party risk as we think about counter-party because these are all cash escrowed pretty much, so it's very positive.

We've got a decent size in the risk transfers. We still manage the portfolio. We still run the client relationship, and if anything, over time, you'll see that the capital velocity of the release of what we get is more ROE enhancing than a book and hold. I can give you the same amount of loan a couple of times over and make more fees with the same client than the limitation that I can't lend more because of capital. I can manage concentration, I can manage industry limits, I can manage single name limits. I free up a ton of capital, so in the short run, it might seem like a revenue reduction but I think if you look at it over 4 quarters, 12 quarters, we'll actually see the benefit of SRTs as a very positive trade.

That's why you're seeing our peers get on the same thing, right? They're all seeing the benefit of what an SRT can do. You still own the relationship. You're never passing over the relationship. You're keeping the relationship, you're keeping the fee opportunity and you're able to lend much more.

Darko Mihelic – *RBC Capital Markets*

And your activity levels you think will be more or less constant?

Piyush Agrawal – *Bank of Montreal - CRO*

Yes, at the moment. There's always investor interest, so it's a function of the liquidity. We're always looking at some, we did a small transaction in Q1, but it's not big on the agenda because we have a very healthy capital ratio. We don't need to do anything right now unless the situation comes up where it's beneficial for the bank.

Darko Mihelic – *RBC Capital Markets*

Okay. On that, I think we've run out of time. Piyush, thank you very much for the opportunity.

Piyush Agrawal – *Bank of Montreal - CRO*

Darko, thanks for having me.

Darko Mihelic – *RBC Capital Markets*

Thank you very much.