Corporate Support

Group Description

Corporate Support includes the corporate units that provide expertise and governance support to BMO Financial Group in areas such as strategic planning, law, finance, internal audit, risk management, corporate communications, economics, human resources and learning. Our operating results include revenues and expenses associated with certain securitization activities, the hedging of foreign-source earnings, and activities related to the management of certain balance sheet positions and BMO's overall asset-liability structure.

Operating results for Technology and Solutions (T&S) are included with Corporate Support for reporting purposes. However, costs of T&S services are transferred to the three client operating groups, and only minor amounts are retained in T&S results. As such, results in this section largely reflect Corporate Support activities.

Financial Results

Net income for the year was $261 million, compared with $23 million in 2003. The improvement was driven by a significantly lower provision for credit losses, as well as higher net gains on investment securities and foreign exchange translation, partially offset by lower net investment earnings in the sustained low interest rate environment and proportionately lower tax benefits in 2004.

Corporate Support is generally charged (or credited) with differences between the periodic provisions for credit losses charged to the client operating groups under our expected loss provisioning methodology and the required periodic provisions charged by the consolidated organization under GAAP. However, during the third quarter of 2004, Investment Banking Group was credited with a $39 million reduction in its provision for credit losses in respect of a recovery on a loan that was written off in 2001. The original specific provision for credit losses on this loan was charged to Investment Banking Group and was not subject to our expected loss provisioning methodology at the time.

Corporate Support, including Technology and Solutions
($ millions, except as noted)

Reported As at or for the year ended October 31	2004	2003	2002	Change from 2003 $	%
Net interest income (teb)	**(187)**	(201)	(160)	**14**	**7**
Non-interest revenue	**203**	255	287	**(52)**	**(20)**
Total revenue (teb)	**16**	54	127	**(38)**	**(69)**
Provision for credit losses	**(545)**	(79)	312	**(466)**	**(+100)**
Non-interest expense	**143**	138	143	**5**	**3**
Income before income taxes and non-controlling interest in subsidiaries	**418**	(5)	(328)	**423**	**+100**
Income taxes (teb)	**98**	(88)	(318)	**186**	**+100**
Non-controlling interest	**59**	60	60	**(1)**	**(2)**
Net income	**261**	23	(70)	**238**	**+100**
Full-time equivalent staff	**6,641**	6,893	7,301	**(252)**	**(4)**

Financial Condition Review

Balance Sheet

Summary Balance Sheet ($ millions)

As at October 31	2004	2003	2002	2001	2000
Assets					
Cash resources	**18,045**	19,860	19,305	17,656	18,508
Securities	**50,472**	54,790	43,715	37,676	46,463
Net loans and acceptances	**156,248**	146,156	149,596	144,765	142,447
Other assets	**40,429**	35,688	40,248	39,312	25,978
	265,194	256,494	252,864	239,409	233,396
Liabilities and Shareholders' Equity					
Deposits	**175,190**	171,551	161,838	154,290	156,697
Other liabilities	**74,420**	69,605	75,338	69,763	59,847
Subordinated debt	**2,395**	2,856	3,794	4,674	4,911
Shareholders' equity	**13,189**	12,482	11,894	10,682	11,941
	265,194	256,494	252,864	239,409	233,396

Total assets increased $8.7 billion or 3% from last year to $265.2 billion at October 31, 2004, even though the weaker U.S. dollar reduced assets by $5.4 billion. There was a $10.1 billion increase in net loans and acceptances and a $4.7 billion increase in other assets. These were partially offset by a $4.3 billion reduction in securities and a $1.8 billion decline in cash resources.

Securities ($ millions)

As at October 31	2004	2003	2002	2001	2000
Investment securities	**15,017**	19,660	21,271	21,470	24,469
Trading securities	**35,444**	35,119	22,427	16,200	21,994
Loan substitute securities	**11**	11	17	6	–
	50,472	54,790	43,715	37,676	46,463

Investment securities decreased $4.6 billion to $15.0 billion, due to a reduction in holdings of U.S. and Canadian government debt related to expectations of rising interest rates. Trading securities were relatively unchanged, as an increase in corporate debt securities related to growth in our credit derivatives business was offset by a decrease in equities due to reduced client activity. Note 3 on page 88 of the financial statements provides further details on securities.

Net Loans and Acceptances ($ millions)

As at October 31	2004	2003	2002	2001	2000
Residential mortgages	**56,444**	52,095	47,569	41,941	39,485
Consumer instalment and other personal loans	**24,887**	22,103	21,168	19,107	18,038
Credit cards	**3,702**	2,967	2,280	1,527	1,407
Businesses and governments	**50,020**	51,889	57,963	61,249	60,176
Acceptances	**5,355**	5,611	6,901	7,936	8,630
Securities purchased under resale agreements	**17,148**	13,276	15,664	14,954	16,308
Gross loans and acceptances	**157,556**	147,941	151,545	146,714	144,044
Allowance for credit losses	**(1,308)**	(1,785)	(1,949)	(1,949)	(1,597)
Net loans and acceptances	**156,248**	146,156	149,596	144,765	142,447

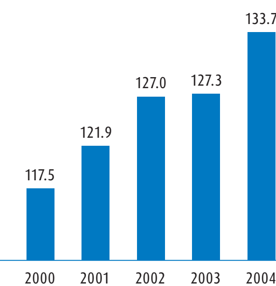
Net loans and acceptances increased $10.1 billion to $156.2 billion. Residential mortgages increased $4.3 billion, reflecting strong market demand in the low interest rate environment. Credit cards and consumer instalment and other personal loans increased $3.5 billion in total, also reflecting healthy personal lending markets. The portfolio remains well diversified, with a higher proportion of Canadian loans due to the growth in residential mortgages in Canada in 2004 and the impact of the lower Canadian/U.S. dollar exchange rate. Loans to businesses and governments and related acceptances decreased $2.1 billion, reflecting weak demand and the lower exchange rate. Securities purchased under resale agreements increased $3.9 billion, reflecting the rising interest rate environment. These instruments are very short-term loans, and increased partly due to reductions in longer-term instruments such as cash deposits with other banks and fixed income investments, which would likely lose more value if interest rates increased as expected.

Table 11 on page 76 provides a comparative summary of loans by geographic location and product. Table 13 on page 77 provides a comparative summary of net loans in Canada by province and industry. Loan quality is discussed on pages 31 and 60 and further details on loans are provided in Notes 4, 5 and 7 to the financial statements starting on page 91.

Other Assets

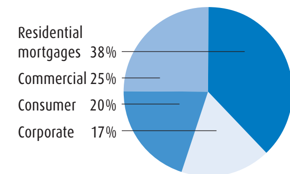
Other assets increased $4.7 billion to $40.4 billion, primarily due to higher values of derivative financial instruments, particularly in foreign exchange and commodity contracts. These contracts increased in value because of the sustained

Net Loans – Excluding Securities Purchased under Resale Agreements ($ billions)



There was strong growth in residential mortgages and personal loans.

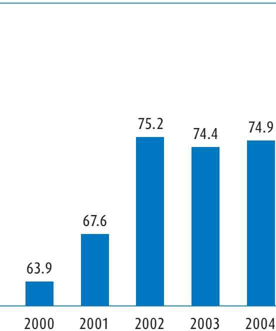
Portfolio Diversification – Gross Loans and Acceptances*



*Excluding securities purchased under resale agreements

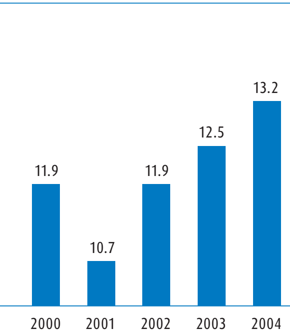
The portfolio remains well diversified, with corporate loans declining as a percentage of the portfolio.

Deposits from Individuals ($ billions)



Deposits from individuals remained stable despite the lower Canadian/U.S. dollar exchange rate.

Shareholders' Equity ($ billions)



Shareholders' equity has increased steadily since 2001 due to net income retained to support our businesses.

lowering of the Canadian/U.S. dollar exchange rate and higher oil prices. These factors caused contract values to rise and the increase in volatility promoted greater client activity.

Deposits ($ millions)

As at October 31	2004	2003	2002	2001	2000
Banks	**20,654**	24,755	15,273	20,539	23,385
Businesses and governments	**79,614**	72,405	71,411	66,132	69,454
Individuals	**74,922**	74,391	75,154	67,619	63,858
	175,190	171,551	161,838	154,290	156,697

Deposits increased $3.6 billion to $175.2 billion, even though the weaker U.S. dollar reduced deposits by $5.1 billion. Deposits from businesses and governments, which account for 45% of total deposits, increased $7.2 billion and deposits from individuals, which account for 43% of total deposits, increased $0.5 billion. The increase in deposits was used to fund growth in loans. Deposits by banks, which account for 12% of total deposits, decreased $4.1 billion. The decrease reflects the reduction in cash resources and securities.

Further details on the composition of deposits are provided in Note 14 on page 105 of the financial statements and in the Liquidity and Funding Risk section on page 64.

Other Liabilities

Other liabilities increased $4.8 billion to $74.4 billion. Accounts payable, accrued interest and other items increased $2.2 billion. Derivative-related liabilities increased $3.3 billion due to the same factors that drove the increase in derivative-related assets. Securities sold under repurchase agreements decreased $2.9 billion, but there was a related $2.2 billion increase in securities sold but not yet purchased.

Subordinated Debt

Subordinated debt decreased $0.5 billion to $2.4 billion due to a $400 million redemption and the lower Canadian/U.S. dollar exchange rate.

Shareholders' Equity

Shareholders' equity increased $0.7 billion to $13.2 billion. The increase was largely related to higher retained earnings. The increase in retained earnings was curtailed by higher income taxes related to gains on hedging our net investment in foreign operations, principally our U.S. subsidiaries; this is discussed further in the Provision for Income Taxes section on page 33. As indicated below, we redeemed our $400 million Class B Series 3 preferred shares and replaced this capital with more cost-effective innovative Tier 1 capital, which is reflected as non-controlling interest in subsidiaries in other liabilities.

BMO's Consolidated Statement of Changes in Shareholders' Equity on page 85 provides a summary of items that increase or reduce shareholders' equity while Note 18 on page 108 provides details on the components of and changes in share capital. Details of our enterprise-wide capital management processes and strategies can be found below.

Enterprise-Wide Capital Management

Strategy and Approach

Our Capital Management Framework is designed to maintain an optimum level of capital in a cost-effective structure that: meets our target regulatory ratios; supports our internal assessments of required capital; results in targeted credit ratings; funds our selected operating group business strategies; and builds long-term shareholder value. Our approach includes establishing limits, goals and performance measures for management of balance sheet positions, risk levels and minimum capital amounts, as well as issuing and redeeming capital instruments to obtain the most cost-effective capital structure possible. These are approved by the Board of Directors pursuant to its annual review of our capital management policy and capital plan.

At the consolidated enterprise level, our targeted capital levels are set in support of our risk appetite, while still satisfying regulatory and legal requirements. At the line of business level, performance measurement is assessed on allocated economic capital, which is based primarily on the assessment and measurement of capital at risk outlined on page 59. By allocating capital internally we ensure that we maintain a well-capitalized position to protect our stakeholders from the risks inherent in our various businesses, while still allowing the flexibility to deploy resources in high-return or strategic growth activities of our operating groups in order to meet or exceed established enterprise targets.

Generally, BMO generates earnings that are sufficient to meet new capital requirements. As such, management's primary challenge is achieving the most cost-effective capital structure, rather than procuring sufficient capital to fund expansion initiatives.

Dividends are generally increased in line with long-term trends in earnings per share growth, while sufficient earnings are retained to support anticipated business growth, fund strategic investments and provide continued support for depositors. BMO's policy is to achieve a dividend payout ratio of 35% to 45% of net income available to shareholders, over time.

The **Tier 1 Capital Ratio** is our key measure of capital adequacy. It is defined as Tier 1 capital divided by risk-weighted assets.

Performance Review

Our common shareholders' equity exceeded our assessment of required capital by $2.3 billion, an increase of $1.6 billion from a year ago. The increase was due to strong net income in 2004, lower economic capital requirements due to our position in the credit cycle, and refinements in the measurement of economic capital. The components of regulatory capital and the measures we monitor are outlined in Tables 20 and 21 on page 80.

The Tier 1 Capital Ratio rose to 9.81% from 9.55% a year ago. Tier 1 capital, representing more permanent forms of capital, increased $1,134 million during the year to $13,471 million, as outlined in the table. Net income was the primary driver of this increase. At year-end, we had $2,485 million of excess Tier 1 capital relative to our minimum targeted Tier 1 Capital Ratio of 8.0%.

Our Total Capital Ratio, which is defined as total capital divided by risk-weighted assets, declined to 11.31% from 12.09% a year ago. The decline related to an increase in risk-weighted assets and the requirement to deduct certain significant investments, effective in 2004, primarily related to our insurance subsidiaries. Both our Tier 1 and Total Capital Ratios remain well above the minimum regulatory targets established by our regulator of 7% and 10%, respectively.

Risk-weighted assets increased $8.2 billion during the year to $137.3 billion, due primarily to strong mortgage and personal loan growth in Personal and Commercial Client Group in both Canada and the United States, as well as the acquisitions of New Lenox State Bank and Lakeland Community Bank in Illinois. In 2005, we anticipate continuing controlled growth in risk-weighted assets and redeployment of capital to strategically advantaged businesses.

The assets-to-capital multiple is calculated by dividing total assets, including specified off-balance sheet items net of other specified deductions, by total capital. BMO's assets-to-capital

multiple increased to 17.0 from 16.4 in 2003, due primarily to an increase in assets. The multiple remains below the maximum permitted by our regulator.

As part of our efforts to optimize our capital structure, we redeemed our $400 million issue of Class B Series 3 preferred shares due to the relatively high dividend rate and the non-tax-deductible nature of the dividend payment. We also issued $600 million of Trust Capital Securities – Series D (BOaTS) – which qualify as Tier 1 capital and pay interest that is not only tax-deductible but is at a lower rate than the non-tax-deductible dividend rate paid on the Series 3 shares.

Dividends declared per common share in 2004 totalled $1.59, up from $1.34 in 2003. This represented a 35% payout ratio, which was at the lower end of our longer-range goal of paying out between 35% and 45% because of particularly strong earnings in 2004 due primarily to very favourable credit performance. BMO increased its quarterly dividend twice during the year, as the quarterly dividend rose to $0.44 per share in the fourth quarter, up 26% from $0.35 in the fourth quarter of 2003. At year-end, BMO common stock provided a 3.1% annual dividend yield based on its closing share price.

On August 5, 2003, we announced our intention to repurchase for cancellation up to 15 million of our common shares. Under the program, which expired on August 6, 2004, 5,123,900 shares were repurchased at a total cost of $271 million. On August 6, 2004, BMO announced a new normal-course issuer bid, commencing August 10, 2004 and ending August 6, 2005, under which BMO may repurchase for cancellation up to a further 15 million common shares. In 2004, BMO repurchased a total of 6,220,500 common shares under our common share repurchase programs at a cost of $333 million.

BMO's credit rating, as measured by Standard & Poor's (S&P) senior debt ratings, remained unchanged at AA–, the highest, along with two of our competitors, of the six major Canadian banks. Our rating, as measured by Moody's senior debt ratings, was unchanged at Aa3, remaining slightly below only one of the six major Canadian banks. Both agencies maintained a stable ratings outlook during the year. These ratings represent a high-grade, high-quality rating.

As outlined on page 57, on November 1, 2004, BMO will be required to consolidate certain customer securitization vehicles, referred to as multi-seller conduits, adding approximately $20.8 billion of assets. This will have the effect of increasing our assets-to-capital multiple on a pro-forma basis to 18.4 from 17.0. The Office of the Superintendent of Financial Institutions (OSFI) has agreed to provide relief from including such amounts in risk-weighted assets for the first two quarters of fiscal 2005, pending further consideration. If risk-weighted asset relief is not made permanent, we may restructure these vehicles.

As explained in the Changes in Accounting Policies in 2005 section on page 57, we will be required to reclassify certain preferred shares as debt in 2005. OSFI has agreed that the reclassified shares may continue to be included in Tier 1 capital.

As described on page 60 in the Enterprise-Wide Risk Management section of the MD&A, the Basel II framework has been finalized. In parallel with the process of developing the risk management models and systems to calculate regulatory capital, we will review our process for assessing overall capital adequacy in relation to our risk profile. This assessment will be subject to review by OSFI.

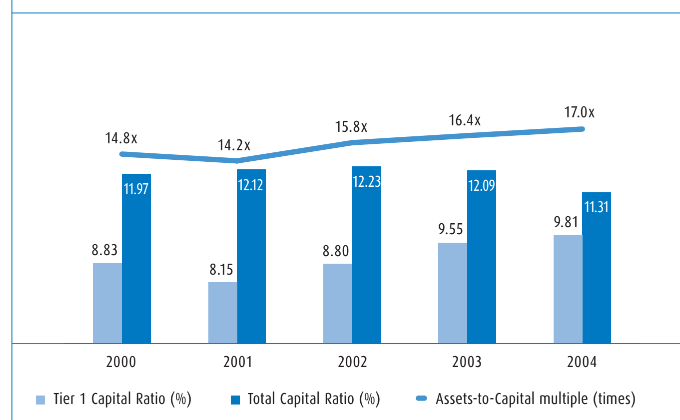
Tier 1 Capital ($ millions)

	2004	2003
Beginning of year	12,337	11,529
Net income	2,351	1,825
Dividends	(873)	(748)
Goodwill and excess intangible assets	(173)	213
Issuance of common shares	242	205
Repurchase of common shares	(333)	(12)
Other issues net of redemptions	195	–
Translation and other	(275)	(675)
End of year	13,471	12,337

Risk-Weighted Assets ($ millions)

	2004	2003
Beginning of year	129,163	131,078
Increases (decreases)		
Personal and Commercial Client Group	5,934	5,397
Private Client Group	(277)	(625)
Investment Banking Group	(9)	(4,670)
Corporate Support	2,512	(2,017)
End of year	137,323	129,163

Capital Measures



Outstanding Shares and Securities Convertible into Common Shares

As of November 23, 2004	Number of shares or dollar amount	Dividends declared per share 2004	2003	2002
Common shares	501,309,373	$1.59	$1.34	$1.20
Class B Preferred Shares				
Series 5	$200,000,000	$1.33	$1.33	$1.33
Convertible into common shares:				
Class B Preferred Shares (1)				
Series 4	$200,000,000	$1.20	$1.20	$1.20
Series 6	$250,000,000	$1.19	$1.19	$1.19
Series 10	$396,000,000	US$1.49	US$1.49	US$1.39
Stock options				
– vested	20,743,510			
– non-vested	9,347,638			

(1) Convertible preferred shares may be exchanged for common shares in future years on a pro-rata basis based on 95% of the average trading price of common shares for 20 days ending four days prior to the exchange date.

Note 18 on page 108 of the financial statements includes details on share capital.

Off-Balance Sheet Arrangements

BMO enters into a number of off-balance sheet arrangements in the normal course of operations. The discussion that follows addresses the more significant types of off-balance sheet arrangements.

Credit Instruments

In order to meet the financing needs of our clients, we use a variety of off-balance sheet credit instruments. These include guarantees and standby letters of credit, which represent our obligation to make payments to third parties on behalf of a customer if the customer is unable to make the required payment or meet other contractual requirements. We also engage in securities lending where we lend either our securities or our customers' securities to third parties. This exposes us to credit risk as a result of the possibility of the third party not returning the securities as agreed. We also write documentary and commercial letters of credit, which represent our agreement to honour drafts presented by a third party upon completion of specified activities. Commitments to extend credit are off-balance sheet arrangements that represent our commitment to customers to grant them credit in the form of loans or other financings for specific amounts and maturities, subject to meeting certain conditions.

There are a significant number of instruments outstanding at any time. Our customers are broadly diversified and we do not anticipate events or conditions that would lead a significant number of our customers to fail to perform in accordance with the terms of the contracts. We use our credit adjudication process in deciding whether to enter into these agreements, just as we do when extending credit in the form of a loan. We monitor off-balance sheet instruments to ensure that there are no undue concentrations in any geographic region or industry.

The maximum amounts payable by BMO in relation to these instruments was approximately $100 billion as at October 31, 2004. However, this amount is not representative of our likely credit exposure or liquidity requirements for these instruments as it does not take into account any amounts that could possibly be recovered under recourse or collateralization provisions. In addition, a large majority of these commitments expire without being drawn upon. Further information on these instruments can be found in Note 5 on page 93 of the financial statements.

Derivatives

Derivative financial instruments are contracts that require the exchange of, or provide the opportunity to exchange, cash flows determined by applying certain rates, indices or changes therein to notional contract amounts.

We structure and market derivative products to customers to enable them to transfer, modify or reduce current or expected risks. We may also take proprietary trading positions in various capital markets instruments and derivatives that, taken together, are designed to profit from anticipated changes in market factors. We also use derivatives as hedges of our own positions.

We enter into derivatives contracts with many different counterparties. Information on the split between financial institutions and other counterparties, by derivative type, is disclosed on page 102 of the financial statements. The geographic locations in which our counterparties operate are detailed on page 101 of the financial statements.

The amount that we are required to pay, if any, under a derivative contract depends on the nature of the derivative. For instance, if we enter into an interest rate swap that requires us to pay a fixed interest rate and the counterparty to pay a floating interest rate, the amount that we would be required to pay would depend on the difference between the fixed and floating rates. If the floating rate is higher than the fixed rate, the counterparty would be required to pay us the difference between the floating and fixed rates applied to the notional amount of the swap. However, if the fixed rate exceeds the floating rate, we would be required to pay the counterparty the difference.

In most cases, we act as an intermediary. As a result, for each derivative liability we usually have an offsetting derivative asset. Therefore, at any point in time our net derivative assets, together with associated capital markets instruments, are not significant.

Trading derivatives are fully recognized on our Consolidated Balance Sheet at their fair values. These trading derivatives represent over 95% of our total outstanding derivatives.

Only our hedging derivatives represent off-balance sheet items, since these derivatives are not recorded at fair value on our Consolidated Balance Sheet. We follow accrual accounting for these derivatives, since they are expected to be highly effective in hedging certain risks associated with on-balance sheet financial instruments or future cash flows. Any ineffectiveness in a hedging derivative is recognized in income over the term of the derivative contract. The fair value of our hedging derivatives was an asset of $867 million and a liability of $462 million at October 31, 2004.

Variable Interest Entities (VIEs)

Customer Securitization Vehicles

Customer securitization vehicles (referred to as multi-seller conduits) assist our customers with the securitization of their assets to provide them with alternate sources of funding. These vehicles provide clients with access to liquidity in the commercial paper markets by allowing them to sell their assets into these vehicles, which then issue commercial paper to investors to fund the purchases. The customer continues to service the transferred assets and is first to absorb any losses on the assets. We earn fees for providing structuring advice related to the securitizations as well as administrative fees for supporting the ongoing operations of the vehicles. For the year ended October 31, 2004, these fees were approximately $96 million.

In general, investors in the commercial paper have recourse only to the assets of the related VIE, unless we have provided credit support for the investors or entered into a derivative transaction involving the VIE.

We provide liquidity and credit support to these vehicles either through backstop liquidity facilities or in the form of letters of credit and other guarantees. The total contractual amount of this support was $27,019 million as at October 31, 2004, of which only $400 million related to credit support. None of these facilities were drawn upon as at year-end.

Derivatives contracts entered into with these vehicles enable the vehicles to manage their exposures to interest and foreign exchange rate fluctuations. The fair value of derivatives outstanding with these VIEs recorded in our Consolidated Balance Sheet was a derivative asset of $52 million as at October 31, 2004.

Interests in Bank Securitization Vehicles

Periodically, we sell loans to off-balance sheet entities or trusts, either for capital management purposes or to obtain alternate sources of funding. BMO recognizes in income the gains on sales to the securitization vehicles as well as revenues paid to us for servicing the loans sold. The impact of securitization activities on our revenues and expenses is outlined in Note 7 on page 95 of the financial statements.

BMO has retained interests in these off-balance sheet entities, as we are sometimes required to purchase subordinated interests or maintain cash deposits in the entities to serve as a source of liquidity for the vehicle. Retained interests recorded as assets in our Consolidated Balance Sheet as at October 31, 2004 were $39 million. In the event that there are defaults in the vehicles, retained interests may not be recoverable and would then be written down. During the year ended October 31, 2004, we wrote down retained interests in securitization vehicles by a total of $19 million.

In addition to retained interests, BMO has deferred purchase price amounts of $143 million related to securitizations recorded in our Consolidated Balance Sheet. This represents the amount of gain on sales to securitization vehicles that has not been received in cash. Further information on the impact of securitization activities on the Consolidated Balance Sheet is outlined in Note 7 on page 95 of the financial statements.

We also provide liquidity to our securitization vehicles in the form of standby letters of credit and guarantees for up to 75% of the asset value transferred. The total contractual amount of standby letters of credit and guarantees, which is included in other credit instruments in Note 5 on page 93 of the financial statements, was $3,750 million as at October 31, 2004. No amount was drawn upon at year-end.

Credit Investment Management Vehicles

Credit investment management vehicles provide investors with investment opportunities in customized, diversified debt portfolios in a variety of asset and rating classes. We earned investment management fees of $31 million in 2004 for managing these portfolios.

We hold an interest in High Grade Structured Investment Vehicles (SIVs). Our exposure to loss relates to our investments to sponsor these vehicles as well as derivative contracts we have entered into with the vehicles. Our investment in SIVs was $128 million as at October 31, 2004 and was recorded as investment securities in our Consolidated Balance Sheet. The fair value of our derivative contracts outstanding with the SIVs as at October 31, 2004 was recorded in our Consolidated Balance Sheet as a derivative asset of $37 million. In order to ensure that these vehicles receive an investment grade rating, we provide liquidity support to the vehicles through standby letters of credit and/or commitments to extend credit. The total contractual amount of these standby letters of credit and commitments to extend credit as at October 31, 2004 was $200 million, which was included in other credit instruments in Note 5 on page 93 of the financial statements. No amounts were drawn upon at year-end.

Financial Instruments

As a financial institution, most of BMO's balance sheet is comprised of financial instruments and the majority of our net income results from gains, losses, income and expenses related to financial instruments. As a result, this MD&A is largely concerned with how we use financial instruments to earn income and manage risks.

Our use of financial instruments exposes us to credit and counterparty risk and various market risks, including equity price risk, interest rate risk and foreign currency risk. A discussion of how we manage these and other risks as well as structural interest rate sensitivities can be found in the Enterprise-Wide Risk Management section on pages 58 to 67 of this MD&A

Further information on how we determine the fair value of financial instruments is included in the Financial Instruments Measured at Fair Value discussion in the Critical Accounting Estimates section on the next page of the MD&A.