

# Investment Banking Group



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## Group Description

Investment Banking Group (IBG) combines all of the businesses serving corporate, institutional and government clients. In Canada, operating under the BMO Nesbitt Burns brand, our client base comprises large corporations and institutions across a broad range of industry sectors. In the United States, operating under the Harris Nesbitt brand, we serve corporate and institutional clients in selected sectors. IBG also serves institutional and government clients in the United Kingdom, Europe and Asia.

We offer clients complete financial solutions across the entire balance sheet, including public and private debt and equity underwriting, corporate lending, securitization, cash management, foreign exchange and trade finance. The group also offers leading financial advisory services in mergers and acquisitions and restructurings, while providing investing clients with industry-leading research, sales and trading services.



## Vision

To be recognized by clients and shareholders as the best and most disciplined integrated North American investment and corporate bank in our markets.

## Strategies

- Continue to reinforce our leading positions in Canada.
- Accelerate growth in the United States.
- Continuously improve the profitability of client relationships.

## Our Lines of Business

**Investment and Corporate Banking** provides a full suite of financial products and services to our clients. Services include strategic advice on mergers and acquisitions, restructurings and recapitalizations, as well as providing valuation and fairness opinions. We provide capital-raising services through debt and equity underwriting. We also provide a full range of loan and debt products, balance sheet management solutions and cash management services.

**Capital Markets** provides integrated debt, currency, interest rate, credit and commodity solutions to targeted wholesale, commercial and retail clients. We also provide efficient funding and liquidity management to BMO Financial Group and its clients.

**Securitization and Credit Investment Management** offers issuers and investors products and services that use credit as a tool for asset management and funding alternatives.

## Strengths

- Well-established franchise with a leadership position in certain industries and products and a reputation for quality advice.
- Top-tier Canadian equity research, sales and trading capabilities.
- Largest presence of any Canadian investment and corporate bank in the U.S. Midwest.
- Cross-border capabilities with the ability to leverage North American expertise.

**Equity Division** offers a comprehensive suite of Canadian equity products globally. These products are delivered through our top-tier research, sales and trading capabilities, and are tailored to our clients' needs. We continue to maintain and enhance our leadership position in Canada, while selectively expanding our product base in the United States.

The **International** line of business provides trade finance and risk mitigation services to North American corporate and commercial clients in support of their international business activities. We also offer a wide range of banking and other operating services to international and domestic financial institutions.

**Merchant Banking** operates through BMO Halyard Partners and BMO Equity Partners. We source, structure and finance private equity investments, primarily in North America.

## Challenges

- Mature Canadian market.
- Highly competitive U.S. investment banking market.
- Competitive credit environment.
- Rising interest rates and flattening yield curve.

| Key Performance Drivers                              | 2005 | 2004 | 2003 |
|--|------|------|------|
| Equity value block trading ranking                   | #4   | #1   | #1   |
| Equity research ranking (Brendan Wood International) | #1   | #1   | #1   |
| Canadian securitization* ranking                     | #1   | #1   | #1   |

\*Asset-backed commercial paper conduit outstandings as at September 30.

## 2005 Group Objectives and Achievements

### Improve client alignment to realize all revenue opportunities.

- Implemented an integrated sector and product coverage model to improve penetration of the U.S. client base.

### Optimize risk-taking to maximize returns.

- Implemented a number of initiatives to align risk management activities.
- Clearly established our risk parameters and tolerances to align with business growth strategies.

### Drive new product development.

- Implemented a new product approval process to increase speed to market of new product initiatives.
- Formed a structured equity derivatives group to focus on the creation and marketing of equity derivative products and solutions (including retail equity-linked

notes) for institutions, corporations and high net worth individuals across North America.

- Launched eFXpedite, an online foreign exchange trading system that lets customers execute trades over the Internet and access foreign exchange prices in real time.

### Improve our cash productivity ratio by at least 150 bps.

- Our cash productivity ratio deteriorated by 320 basis points due primarily to below-target revenue growth and a shift in revenue mix whereby growth occurred in businesses with higher variable costs. Investment Banking Group's productivity ratio was ranked second in its Canadian peer group for 2005.

### Other Achievements

- Record net income in 2005.
- Expanded and upgraded IBG's U.S. talent through a number of key hires in our mergers and acquisitions, commodity derivatives, and equity research and sales groups in the United States.
- Ranked Top Overall Equity Research team in Canada in the Brendan Wood International Survey for the 25th consecutive year.
- Expanded our real estate investment and corporate banking group within Canada. This broadens and deepens our ability to provide a full range of products and services to public and private real estate companies and to major pension funds with real estate portfolios.
- First and only Canadian bank to be awarded a local currency banking licence in Guangzhou, China.

## Everyday Priorities for 2006

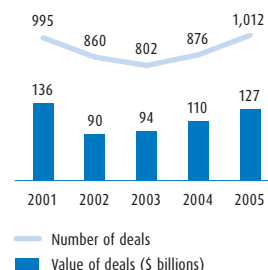
- Continue focus on integrated coverage to bring the best solutions to our clients.
- Refine sector focus to match product and service capabilities in the United States to high-growth opportunities.
- Develop U.S. investor strategy to accelerate growth of this business.
- Improve our cash productivity ratio.
- Implement high-value initiatives that build on both existing expertise and businesses and new business ideas.

## Business Environment and Outlook

Market conditions were mixed in 2005, characterized by high price volatility in the energy sector, favourable capital markets activity, a weak U.S. dollar, moderate economic growth, rising short-term interest rates primarily in the United States and the resulting flatter yield curve. This contributed to improvements in trading revenues, merger and acquisition activity and securities trading commissions. The less than favourable interest rate environment compressed spreads in our interest-rate-sensitive businesses and the weak U.S. dollar lowered revenues. Commercial and industrial loan demand continued to strengthen in 2005 in both Canada and the United States. The group continued to experience a very competitive environment in the United States, where margins have been under pressure.

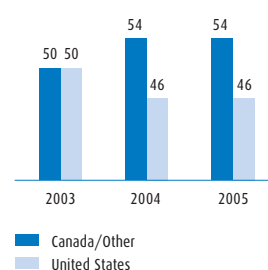
Looking forward, further customer consolidation and new trading technologies are expected to continue to put downward pressure on equity trading commissions. We expect that rising short-term interest rates and the resulting flattening of the yield curve will continue to challenge our interest-rate-sensitive businesses, although the rate changes in the United States should be more modest than in 2005. Loan growth is expected to continue to increase after several years of

### Canadian Mergers and Acquisitions Market (for the 12 months ended September 30)



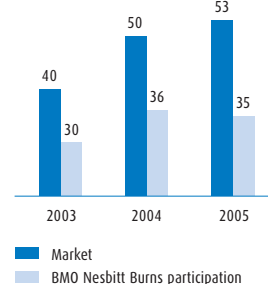
The mergers and acquisitions market has continued to improve.

### IBG Revenue by Location (%)



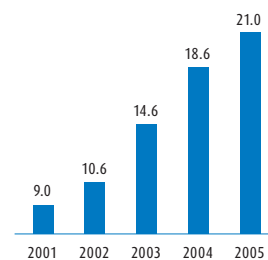
U.S. growth has stabilized but remains a priority.

### North American Equity Underwriting – Canadian Issuers (\$ billions)



Our share of equity underwriting remains high.

### Return on Equity (%)



ROE has grown steadily.

decline, although pricing will remain competitive, particularly in the United States. Increasing our fee-based and advisory revenues continues to be a focus in 2006 but will depend on the general business climate, inflationary pressure and the impact of record energy prices.

### Investment Banking Group Financial Results

Investment Banking Group net income rose \$20 million to a record \$852 million. Performance in both 2005 and 2004 was affected by significant items. Results in 2005 included a \$44 million (\$37 million after tax) gain recognized on restructuring VIEs and a \$32 million recovery of prior years' income taxes. Results in 2004 included the \$38 million after-tax impact of amounts recovered on a loan that had previously been written off and \$44 million (\$29 million after tax) of interest expense on the unwinding of hedge contracts associated with fixed income investment securities that were sold. Adjusting for the foregoing items in both periods, net income would have decreased by \$40 million. In 2005, net investment securities gains were increased by the \$50 million impact of gains recognized on a change in accounting for merchant banking investments and by the group's \$25 million share of the gain on sale of TSX common shares; however, net gains were also high in 2004, and increased by only \$4 million to \$143 million in 2005.

Revenue in fiscal 2005 declined \$27 million or 1% to \$2,741 million. The weaker U.S. dollar lowered revenue by \$110 million or 4%. Improved non-interest revenues were more than offset by reduced net interest income. Higher non-interest revenue was largely due to the revenue recognized on restructuring VIEs and significantly higher trading revenue. Commodities trading revenue was up appreciably due to high volatility and active markets. Interest rate trading revenues were up strongly and foreign exchange trading revenues also rose, while equity trading revenues declined. Merger and acquisition fees were sharply higher in a strong market and commission revenues also improved. Equity and debt underwriting fees were both down slightly relative to a strong 2004. Net interest income declined due to compressed spreads in our interest-rate-sensitive businesses. This was largely due to the rising short-term interest rate environment, the flatter yield curve, lower spreads on corporate loans and our strategy of reducing non-core assets. Higher funding costs of our increased commodity and equity trading businesses also contributed to the decline in net interest income.

The provision for credit losses was \$98 million in fiscal 2005, compared with \$138 million in 2004. The reduction was due to lower expected credit losses. Results in 2004 included a \$39 million recovery on a loan that was previously written off. BMO generally charges the client operating groups with expected credit losses, as explained on page 57; however, IBG was credited with this recovery in 2004 because the loss on the loan in 2001 was not subject to our expected loss provisioning methodology at the time.

Non-interest expense was \$1,477 million, up \$72 million or 5%, due primarily to higher performance-based compensation. The group's fee-based revenues, which typically have relatively higher variable costs, were strong relative to 2004. Revenues in interest-rate-sensitive businesses, which typically have relatively lower variable costs, were down appreciably in 2005. The weaker U.S. dollar reduced expenses by \$45 million or 3%.

### Investment Banking Group (\$ millions, except as noted)

| Reported                                       |  |         |         | Change from 2004 |        |       |
|--|--|---------|---------|------------------|--------|-------|
|  | As at or for the year ended October 31 | 2005    | 2004    | 2003             | \$     | %     |
| Net interest income (teb)                      |  | 965     | 1,260   | 1,344            | (295)  | (23)  |
| Non-interest revenue                           |  | 1,776   | 1,508   | 1,244            | 268    | 18    |
| Total revenue (teb)                            |  | 2,741   | 2,768   | 2,588            | (27)   | (1)   |
| Provision for credit losses                    |  | 98      | 138     | 231              | (40)   | (29)  |
| Non-interest expense                           |  | 1,477   | 1,405   | 1,345            | 72     | 5     |
| Income before income taxes                     |  | 1,166   | 1,225   | 1,012            | (59)   | (5)   |
| Income taxes (teb)                             |  | 314     | 393     | 321              | (79)   | (20)  |
| Net income                                     |  | 852     | 832     | 691              | 20     | 3     |
| Amortization of intangible assets (after tax)  |  | 2       | 1       | 1                | 1      | 55    |
| Cash net income                                |  | 854     | 833     | 692              | 21     | 2     |
| Net economic profit                            |  | 417     | 358     | 187              | 59     | 16    |
| Return on equity (%)                           |  | 21.0    | 18.6    | 14.6             |        | 2.4   |
| Cash return on equity (%)                      |  | 21.0    | 18.7    | 14.6             |        | 2.3   |
| Non-interest expense-to-revenue ratio (%)      |  | 53.9    | 50.8    | 52.0             |        | 3.1   |
| Cash non-interest expense-to-revenue ratio (%) |  | 53.9    | 50.7    | 52.0             |        | 3.2   |
| Average net interest margin (%)                |  | 0.59    | 0.89    | 0.93             |        | (0.3) |
| Average common equity                          |  | 3,967   | 4,382   | 4,637            | (415)  | (9)   |
| Average assets                                 |  | 163,848 | 141,691 | 144,418          | 22,157 | 16    |
| Risk-weighted assets                           |  | 57,685  | 50,814  | 50,823           | 6,871  | 14    |
| Average loans and acceptances                  |  | 48,349  | 43,454  | 48,225           | 4,895  | 11    |
| Average deposits                               |  | 71,883  | 67,369  | 59,136           | 4,514  | 7     |
| Assets under administration                    |  | 57,694  | 58,026  | 71,098           | (332)  | (1)   |
| Assets under management                        |  | 21,871  | 18,761  | 20,013           | 3,110  | 17    |
| Full-time equivalent staff                     |  | 2,156   | 2,129   | 2,141            | 27     | 1     |

| U.S. Business Select Financial Data (US\$ millions) |                               |        |        | Change from 2004 |       |    |
|---|-------------------------------|--------|--------|------------------|-------|----|
|   | For the year ended October 31 | 2005   | 2004   | 2003             | \$    | %  |
| Total revenue                                       |                               | 1,037  | 977    | 901              | 60    | 6  |
| Non-interest expense                                |                               | 519    | 518    | 444              | 1     | -  |
| Net income  |                               | 284    | 251    | 190              | 33    | 13 |
| Average assets                                      |                               | 37,484 | 30,440 | 33,747           | 7,044 | 23 |

The group's productivity ratio deteriorated 310 basis points to 53.9%. The aforementioned shift in the business mix favouring businesses with relatively higher variable costs affected the productivity ratio in 2005. Although the group's productivity ratio deteriorated, it was the second best of its Canadian peer group in 2005.

Net income from U.S. operations represented 41% of the group's net income in 2005, comparable to 40% in 2004. Our U.S. investment banking operations are primarily directed at mid-market corporations having revenues that range from US\$50 million to US\$1 billion. Overall revenues and net income of the mid-market banking unit declined from 2004 due to lower spreads in both corporate banking loans and cash management services. Corporate banking assets continue to grow, while deposits have declined in cash management. In 2005, the revenue from our mid-market portfolio represented 16% of total group revenue and 34% of our U.S. revenue. Often, such activities are included in personal and commercial banking units by our North American peers. Pro-forma results, reflecting our U.S.-based mid-market business as part of Personal and Commercial Client Group, are included in that group's section of the MD&A on page 48.