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PRESENTATION

Operator

Good day, everyone, and welcome to the Banorte Second Quarter 2017 Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Ursula Wilhelm. Please go ahead.

Ursula Margarete Wilhelm Nieto

Thank you, Dana. Hello, everyone, and welcome to Banorte's second quarter earnings call. I'm Ursula Wilhelm, Head of Investor Relations. And this morning, Marco Ramirez, Chief Executive Officer, will give you details into this quarter's results. With him are senior executive officers who will also take part in the Q&A session. May I remind you that today's discussion may include forward-looking statements that are subject to risks and uncertainties that might cause actual results to differ materially. Marcos, please go ahead.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Ursula. Thank you, and good morning, everyone. I'm pleased to report to shareholders that the group delivered another quarter of good operating and financial results. We're in to the second half of the year and the Mexican economy has demonstrated to be resilient. There was significant pessimism and uncertainty at the beginning of the year, yet the economy has performed far better than expected and the operating environment has been more benign than initially anticipated. In this context, Banorte reports another quarter of solid results and improving financial performance.

I will start on Slide 2, commenting that earnings growth was again the result of the strong performance across all subsidiaries. We continued to see the benefits of the higher interest rates repricing on the balance sheet. Discipline in cost management delivered savings, which offset slightly higher provisions during the quarter. Earnings per share grew 23% yearly or 3% in the quarter, reaching at MXN 2.05 per share, in line with our net income guidance. Profits for the first half reached MXN 11.2 billion, delivering an all-time high ROE of 16.1%, demonstrating that we continue to make progress towards our 2020 objectives.

On to Slide 3. Total quarterly revenues of MXN 19.9 billion for the group grew 19% year-over-year, with a strong contribution and double-digit growth from all lines: net interest income, fees and trading income.

The net interest margin for the quarter, on Slide 4, reached 5.4%, declining 13 basis points. The decline is driven by the seasonality of the insurance business in the first quarter of the year, with larger-than-usual insurance renewal activity. The net interest margin excluding Insurance and Annuities stood at 5.3%, unchanged versus the prior quarter on a temporary smaller contribution from the repos. Our

expectation is that the net interest margin should continue expanding in the coming quarters, as the assets carry on their repricing dynamics. The net interest margin of the bank grew an additional 11 basis points in the quarter.

Total expenses, in Slide 5, were down by MXN 328 million during the quarter as we have aligned expense management to achieve our annual growth target. Similarly, the efficiency ratio achieved a solid result, declining 260 basis points to 41.9% on a wider operating leverage.

Continuing on loan growth, the credit book expanded 13% annually with positive growth in all portfolios. Despite increases in interest rates, loan demand is active and our pipeline is robust for the coming months. Therefore, we are revising upwards our loan growth guidance for the year to a range of 10% to 13%.

Growth in the consumer portfolios continues to be largely driven by penetration with our existing customer base. And the cross-sell ratio stands at 1.875 products per customer, higher than the 1.834 ratio of last year.

Asset quality metrics, on Slide 6, remain solid with the overall NPL ratio stable at 1.8%. However, there was some deterioration in the consumer books related to the seasonal behavior where NPL formation peaks around the middle of the year and then tends to stabilize towards the end of the year. The NPL ratios of the consumer portfolios are higher from the previous quarter, yet they remain within a healthy range.

Development in the consumer market remains constructive. Growth in employment is positive, while more importantly for us, formal employment is progressing. The latest numbers of June show formal employment growing at historically high levels. Also, salary increases have been improving, with the latest data showing that average wages were revised upwards by 5.3%.

Loan loss provisions, on Slide 7, totaled MXN 4 billion in the quarter, bringing cost of risk to a high 2.8%. Provisions move in tandem with NPL formation in the consumer books, but there was an additional MXN 270 million provision related to loan origination in the wholesale books. We expect cost of risk to align to the guidance range going forward.

Moving to capital, on slide 8. The capital adequacy ratio of the bank was 15.05% in June, down from 16.58% in March. The decline mainly reflects the declining core capital because of the dividend payment recently completed. Furthermore, the bank successfully raised a \$900 million AT1 capital perpetual notes in the international markets. It was done in 2 tranches with call dates from 5 and 10 years. The blended cost was 7.25%. We did very well financing the peso equivalent of our own \$400 million of subordinated debentures that either have (inaudible) or lose value on the regulatory capital because they are Basel II legacies. The capital note is still not reflected in the June ratio, since it will be accounted for in the third quarter. Therefore, on a pro forma basis, we estimate that the capital adequacy ratio for the bank will be around 18%, including the note.

Finally, I want to mention a few more updates to the 2017 guidance in Slide 9. Based in our current estimates, we are revising the net income range to be between MXN 22.7 billion and MXN 23.5 billion and the estimated ROE between 15.5% and 16.2% for the full year. We are anticipating a stronger annual efficiency ratio between 42% and 44%, while the tax rate will be slightly higher than originally expected. These changes demonstrate our strong confidence that we are on track to deliver better financial and operating results in the second half of this year.

Thank you. With this, I conclude my comments and we are ready to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll go first to Tito Labarta with Deutsche Bank.



Daer Labarta Deutsche Bank AG, Research Division - Senior Analyst

I guess, my main question is in terms of asset quality and provisions. I know you mentioned some seasonality impacts the consumer portfolio. We have seen that in the past. But given the loan growth that you're seeing of 22% year-over-year in the consumer portfolio, that means NPL formation is pretty high. So just wanted to understand, how comfortable you are that asset quality will improve in that segment or that there won't be deterioration kind of longer term. Also in terms of the provisions, I know you booked about MXN 1.1 billion in additional provisions related to the new regulations from the CNBV for consumer and mortgage loans. Is that just this one time, I imagine, or any other provisions you need to book for that? And so I guess, in terms of the cost of risk, you still feel comfortable it will be within the range that you've given, the 2.4 to 2.6? It seems like it was -- should be at the higher end after the quarter.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Thank you, Tito. Yes, we're comfortable with the asset quality and all the provisions. And the new regulations, you are right, but we don't expect more hits there. Rafael will give us more color there.

Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance

Yes, Tito. Yes, as you know, we have been achieving very strong growth on the consumer, as you mentioned. And -- but it's very important to understand that basically we are growing our -- with our own client base. Since we are deploying most of the multichannel approach already in the ATMs, on the mobile and on the web, what you will see, this acceleration in the loan growth is not because we are aggressively going into the market. It's because we are really being able now by using all these channel distribution capabilities to really target the clients in a good way. If you look at the numbers, compare 1 year to the other about the seasonality that Marco was referring, you will see that credit cards have exactly the same level that was in the last second quarter of past year. But we are also getting extremely good results on SMEs, on mortgages and car loans, much better than expected. So the 1.8% really reflects the quality of the book. We're already taking measures that we usually take around this part of the year with especially the credit card portfolio related to really being specific about which clients we want to increase our penetration with. So what you will see in the -- basically in the fourth quarter is a steep decline in the NPL formation for the credit card business. The other portfolios, as we mentioned, are performing very, very, very well. Even payroll, there was an issue last year because of one large issue, continues to perform in the right direction. So the penetration that we have on the market has to do with -- we are really targeting our clients. We have been very respectful of the profitability that the clients already had with us. So we can really manage the relationship on a price risk basis that is advantageous to our clients and is very beneficial on the risk-adjusted margin. So that's the reason why we are growing on the portfolio. It's not that we are aggressively going into the open market. It's far from that. It's very, very concentrated on what we have, on what we can really target to these clients. On the regulation piece, no, we don't expect anything more from that. It was one time. It was already provided on the budget, so no -- nothing -- there was no surprise on that part. So the 2.4 to 2.6 that we committed to the guidance, we are confident that we will reach that number.

Daer Labarta Deutsche Bank AG, Research Division - Senior Analyst

Very helpful. And then maybe just one follow-up, this one on expenses. Since this fell in the quarter, but you had anticipated some expenses in the first quarter, so it was expected to decline. And on a year-over-year basis, you are running above the guidance. So -- I mean, do you expect expenses to continue to decline to meet that guidance? Or anything that was extraordinary there that impacted expenses in the quarter?

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Yes, we have some expenses that we knew that we needed to pay and because of the FX and whatever. But we will meet our target for the rest of the year. We don't see any problem there.

Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance

And adding to what Marco says, as you saw, the reduction was 4% on a quarter-to-quarter basis. And you will continue to see a reduction from the remaining of the year. So we are -- we continue to see that we will meet our guidance on the cost that we guided at the end -- at the beginning of the year.

Operator

We'll go next to Mario Pierry with Bank of America Merrill Lynch.

Mario Lucio Pierry BofA Merrill Lynch, Research Division - MD

Let me ask you 2 questions. The first one is related to your capital. As you mentioned, your capital ratio improved to about 18% following the issuance of these Tier 1 capital notes. I wanted to understand possible uses of this capital. What do you think to be an optimal level of capital that you want to be operating at? And just to make sure also that the financial expenses related to these notes, they do not impact your P&L, they will impact your equity. Second question I have is if you could discuss a little bit the -- if we have already seen the full impact of the interest rate hikes on your net interest margin or if you still see room for margins to expand. And here my main concern is related to competition. Although I think, right, that your margin probably has room to expand because of the rate hikes, I wanted to understand a little bit better the competitive environment in Mexico last time we were there. In May, we heard that a lot of your peers were also trying to gain market share, being more aggressive in lending. So are we seeing any pricing competition? That's it.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

Thank you, Mario. The first one, the capital, yes, we will get to 18% and Rafael will explain what are we going to use the proceeds. But it's the Basel II that -- and also that we will lend more dollars. But again, Rafael is going to explain there. And yes, there is a lag in the interest rate, so there is a room for improvement yet because this lag that we always have, and we expect the next quarter and maybe the other next quarter to continue to improving the interest rates hike. And also Rafael will give us some color about that.

Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance

Yes. Thank you, Mario. As Marco said, the capital ratio, basically what you see is that we substitute prepayments that we needed to -- as you know, we always honor our calls. And we have called around \$600 million of notes that were on the Basel II that were completely out of efficiency by now. What you will see is that \$900 million, part of that is related to that substitution now, so that on the rate on the Basel III, the Tier 1 comes full into additional Tier 1. So that's what you see, a big hike on the growth on the capital base. As Marco says, we see good demand in the dollar book. And as you know, there's always opportunities for specific portfolios that we are looking in the market. And we can see that there's -- can be good possibilities in that specific portfolio that we would like to buy. The other part is related to the levels of capital. What we have committed to our investors is that the Tier 1 -- the core Tier 1 should be around 12 to 12.5, and total cap will be for around 15 to 15.5. As you see now, we have additional capital. As you -- and there is -- we see possibility to really make that capital efficient in a very fast way. You will see that the effect, if we don't do anything on the capital for the ROE for the end of the year, we'll be -- at the end of the year, ROE will be around 16.2, so very in line with the guidance. But there's still room to make that capital much more efficient from now on. So that's related to the capital ratio and the levels and the use of proceeds. On the P&L, what you will see is MXN 400 million will be of additional benefit on the P&L this year, and MXN 900 million in additional benefit if we don't do anything, by just investing the capital on a very straightforward basis. So it's a positive way. Why? Because we substitute high-cost debentures that we have by a much more cost-efficient capital base.

On the net margin, yes, we continue to see expansion on the margin. Because as you know, the moment you have a hike in the interest rate, that immediately affects the liability side. And especially on the consumer book, that get affected on day 1. And the repricing starts flowing to the P&L from 8 to 12 months. So yes, we continue to see expansion on the margin to meet our guidance a little above what we see now. On competition, if you see the numbers for the bank, and this is based upon what you can see on the CMBB. On demand deposits, the bank continues to be very, very strong. We are growing above 10% on demand deposits. And on time deposits, we are still the leader in time deposits, growing very strong in time deposits, but we are taking very good care of the cost also. So our mix continues to be 67% on demand deposits, and we are very comfortable with the cost of funds. Remember that when you see the demand deposit piece, the demand deposit that we are having and incurring in a high cost last year, we start to really deploy those out of the balance sheet. So we got rid of around MXN 32 billion last year or at the beginning of this year of high cost funding that we really don't need. So yes, there is competition, but I think we have a very good business model that has been a proven track record in acquiring deposits on a very efficient way, the same as the time deposits. Competition is always there. It's always there. But I think we have a pretty good business model to attract deposits.

Mario Lucio Pierry BofA Merrill Lynch, Research Division - MD

Okay. Let me go back to what you mentioned, Rafael, about the opportunities for specific portfolios that you could be pursuing. You're talking about specific loan portfolios? Or are you talking about potential acquisitions as well in Mexico? And also if you would consider paying a special dividend if you don't make any acquisitions?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes -- no, we're talking about basically portfolios. And that can be loan portfolios, can be any type of portfolios because remember that we are a very well-diversified financial group. So we have opportunities in the leasing, in the insurance business, in the pension business, in many businesses. So we are always looking for ways to make profitable investment of capital that we have for our shareholders. And also, we also -- as you know, we have always been very clear to the market that we stick with a policy of 40% dividend. But on a tactical basis, there's always the possibility for extraordinary dividend.

Operator

We'll go next to Jason Mollin with Scotiabank.

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

My first question is related to the evolution of shareholders' equity or book value during the quarter. If we exclude the impact of the -- I calculate MXN 11.2 billion paid in dividends and the much smaller share buyback, we see that the book value did not grow in tandem or in line with earnings. In fact, the book value was hit by almost MXN 800 million in the quarter in my calculation. And according to the release, we saw that this was due, and you talked a little bit to the loan loss provisions taken against equity, the valuation of securities for hedging and the valuation of the defined benefit pension for pension plans for employees. So this is now the third quarter in a row that we see a hit to book value. Should we expect this trend of book value not moving in line with earnings, adjusted for dividends and buybacks, to continue in the future? And my second question is related to the revised guidance for net income and ROE and this impact in book. Because at the low end of the earnings expectation, net income expectation, you increased by 2%, but the low end of the ROE increases by 5%. So it appears that some of the increase in the expected profitability is because of the lower book value. I just wanted to make sure, is that part of the calculation? Because now we had a hit of, I think it was about MXN 1 billion in the last quarter and MXN 6 billion in the fourth quarter, what some might call other comprehensive income.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Okay. Thank you, Jason. The first one obviously is not -- evolution of book value will not continue on that track. And the guidance, (inaudible) back to Rafael.

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes -- no, Jason, let's do a very quick calculation. I mean, if we -- if you are looking at the guidance number, you're looking at MXN 23 billion of net income, but that will be -- that will flow directly into capital. If you take away 40% of the dividend, you're looking at MXN 9 billion. So you will have close to MXN 12 billion -- at least MXN 12 billion more to the capital book. If you look at the number for the capital creation at the end of the year, it will be in line -- starting to be much more in line with the earnings growth. The other number that you have to look is not -- it was not MXN 11 billion. It was MXN 14 billion that we really paid for the dividends, considering the extraordinary dividend piece. As you saw, there was a regulatory charge that we had of around MXN 1.1 billion for the regulatory adjustment on the mortgage and on the payroll. And the remains -- as you say have been valuation processes. As you know, and let me give you an example, PEMEX was hitting the valuation around MXN 2 billion in a negative way a year ago. Now it's positive around MXN 600 million. So we are very consistent and we are very open in how we disclose the movements in capital. We don't expect any charge to the capital numbers that are not present in that book. What you will see is that creation of capital because you will see that net income will at least be growing around 18%, and the loan book is going to be around 5% -- 13%. So that will continue to add capital and add value to the book for the shareholders. And I think we also want to be efficient on that part. And we are keeping a very, very close look at earnings growth and also the necessary creation of value for the shareholders is our main mandate. So I think you will be -- if we have this conversation at the beginning of the next year, you will see a completely different picture for what you now are mentioning. That is correct exactly, what you mentioned. But you have to see forward-looking on this piece. And remember another piece, Jason. Banorte was always very late in paying the dividend flow. We were always as late as 2 years in really catching up for the current year. Since this year, we are -- we catch this past year and the remainder of the year before this one. So all that has been an adjustment that really was -- now I would say it's completely clean. We have been paying the dividend on a basis exactly after the year-end. So in the past, that was not the case. So there was an artificial creation of book value on the numbers.

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

Let me just confirm that -- so through June, I do have that MXN 14 billion in dividends. But if we take out what was already paid through March, at least according to your disclosure, was 3.422. So in this -- I just want to confirm that in the second quarter, the dividend calculation I have, the change from the first to the second was MXN 11.234 billion. Is that accurate? The MXN 14 billion was...

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

That's right.

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

Correct?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

That's correct, Jason. The number that was mentioned to you, it was the full year of what we have paid for the full year. No, you are correct.

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

Okay, that -- I think this happens, and I don't -- I mean -- and we did see the revaluation of securities have a positive impact in the quarter, which I thought, given how well the markets reacted, we would -- this could be a quarter where you made up some of the losses. But I guess, I didn't have this provisioning hit. So going forward at this point, we should not expect any other, let's call it, impacts on book. Of course, the market's going to move. What about these issues on the pension, the defined pension? That -- this is, I think, the second quarter in a row we saw that you had to take a charge. Is that just related to the movement of interest? What's driving that?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

No, that's adjustment that we have with the actual numbers that we have to calculate on a yearly basis. So that adjustment -- I think you will see that next year it will be a lot less because it was a catch-up because of a change in the numbers -- in the actual numbers that we needed to do.

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

And the hedging -- and this hedging of securities charge, that's the opposite of -- like are you hedging -- is this hedging like your mortgage book or your investment portfolio? Where...

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

(inaudible)

Jason Barrett Mollin *Scotiabank Global Banking and Markets, Research Division - MD of LatAm Financial Services*

Sorry, please repeat that?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

It's the mortgage book, Jason.

Operator

And we'll go next to Jorg Friedemann with Citi.

Carlos Rivera *Citigroup Inc, Research Division - Senior Associate*

I'd like to make some follow-ups. Given these new reserves that were booked, would it be fair to say that the current level of coverage, which surpassed already 140%, should be the new normal going forward? And my second question, I also noted that you had this negative



seasonality in terms of insurance. But in the past year, it represented approximately 23% of your total results, at least taking into consideration also annuities. So what is the reasonable participation of final -- long-term savings as a percentage of total earnings going forward?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Carlos. The first one, yes, there is -- these are new normal -- the new reserves and that's it. And the second one, maybe Fernando can help us a little bit here. Fernando?

Fernando Solís Soberón *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Long Term Savings*

Yes. With respect to the [stability] of last year with regard to this year's comparison quarters, the -- actually, what I have to mention first is that the rumor that we have the new regulation being introduced last year. And because of that, we have, up to this date, an extraordinary net income of more or less MXN 150 million. So actually if you take that into consideration, actually the insurance business is doing much better than has been shown in the numbers. If you take that number out of -- as a nonrecurrent item, actually the increase would have been more or less 32%. So it's growing even faster than what you have seen because of that fact. And moving forward, with respect to how much the long-term savings will be of net income of the group, I would say that it should be somewhere between 20% to 23%. It mainly explains is because insurance and the pension business are going to keep growing, I would say, in a very important fashion and manner. And remember that (inaudible) mature assets -- actually you have seen that it only grew 2%, but we also have some nonrecurring items because we are making a provision that was not expected to pay a fine. And actually -- if we take that out of the number, actually the number would have been 9.2 increase instead of the 2% that you have seen this year. But that asset is not going to be growing as fast as the other 2 and actually is not going to grow as fast as the other -- well, mainly the bank or some other of the subsidiaries. So I would say somewhere between 20 to 23%, but hopefully much more. We will see.

Carlos Rivera *Citigroup Inc, Research Division - Senior Associate*

That's very clear. If I may, I just like also to do a new follow-up. You mentioned before that the impact of the repricing of the book on higher rates takes from 9 to 12 months. What is your expectation at this point for rates to start to go down in Mexico?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Carlos, we don't know obviously. Nobody knows actually. [Banco de México] doesn't know because they need more data and they need to move. But it's going to be -- maybe next year, maybe at the beginning, maybe in the middle, maybe at the end. And we still don't know. I will ask Casillas to talk about that. But we should be prepared, and that's it. Please, Casillas, go ahead.

Gabriel Casillas Olvera *Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis*

Thanks, Marcos. It's Gabriel Casillas, Chief Economist, Carlos. One thing, we expect interest rate to remain stable. I mean, it's going to be hard for central bank to do something to ease rates. As you know, we're having elections next year. Inflation so far will continue to go up on an annual basis. Actually, we're expecting inflation to go up to 6.5% by the second half of August. And then it is not fully clear, even though it's going to start to go down, but it will be -- it will convert rapidly to 3% sometime next year. So -- and on top of everything, one thing that Marcos mentioned at the beginning was the fact of employment. Formal employment has been increasing like never. I mean, as you know, in this first half of the year, formal employment creation was about 517,000 jobs. And, I mean, with this unemployment rate that actually was released like an hour ago, it's an all-time low. So in this context, it's going to be hard for central bank to really be able to do that. And on top of everything, we will have a new governor, at least in December. So many, many, many things, as Marcos mentioned, made us think that it's going to be very hard to know, but it's not going to be in the short term -- in the short run. Also, Rafael wants to add something too.

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes, Carlos, I think it's quite important what you mentioned about this effect on the flowing through the P&L of the consumer book. And if you look at the commercial and the corporate book and the government book that we own, I mean, the increase in the risk-adjusted margin has been very, very, very strong, 30%, 40% at least. And the consumer has been very slow to reprice. So if you see that the interest rate starts to -- let's imagine that starts to go down next year, then the consumer books will be providing very good risk-adjusted margin, and the commercial and the government will start to really be a little less strong on that part. So it's a very -- it's a balancing act and we are following that very closely. So we are confident in either way. I mean, if the interest rate starts to go down, you will see pretty good strong margin

growth in the consumer book, reasonably reduction in the -- on the corporate, and the government and on the commercial book. But overall, it will be extremely positive for the bank.

Operator

And we'll go next to Thiago Kapulskis with BTG Pactual.

Thiago A. Kapulskis *Banco BTG Pactual S.A., Research Division - Associate*

I have a couple of questions. The first one is in terms of loan growth. We've been seeing the acceleration this quarter. And I'm just wondering, what is exactly leading to that? If you could give some color on what you see there. And also looking forward, right, thinking about elections and all the uncertainty next year, could that lead to some reduction in the appetite to grow? And how do you see growth next year on your loan book? That will be my first question. And the second one, in terms of cost to income, we've seen a really good number this quarter. And I'm also wondering how low can you go? Could the bank sustain such levels going forward or not?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Thiago. The first one, we have a strong pipeline to believe that the loan growth is going to be there, at least for this year -- the remaining of the year to -- it's going to be 10 to 13. We changed that in the guide. And we changed it upwards because we think that -- we see the pipeline and we can talk about that. We still don't know what's going to happen next year, maybe because of the election it's going to decrease. This rationale is cyclical (inaudible). But we will save that for the next year when we are right there. We need more data to answer you that. And the cost to income, yes, it's good. It's 43%, 42%. And if we see our peers worldwide, it's reasonable to be there if we do the right thing. And we stay to be there and to normalize there actually. Banorte should be there, why not? I don't know. Rafael, do you want to say something about that?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Totally the same that Marcos says. We are committed to the cost to income ratio as part of our commitment to the 2020 numbers. And the cost to income ratio, the same that ROE, the ROA, the net interest margin, the cost of risk, all those numbers are followed very closely on a monthly basis. And we are on track on every one of them. So we are not confident in a way that we are comfortable, but we are seeing that if we do the right things, we can achieve what we committed.

Operator

We go next to Claudia Benavente with Santander.

Claudia Benavente *Santander Investment Securities Inc., Research Division - Research Analyst*

My first question is like we saw an important growth on the credit card loan portfolio of 25% in the last month and 20% in the last 2 months. Is this a pattern that we should continue serving looking forward? And have you lent to current clients? Or did you increase -- gave lending to new clients? My second question is regarding the insurance business. I understand that you have given an insurance product to only 7% of current clients. Has this number changed this quarter? And should -- could we see an acceleration on the revenue growth of more than 20% year-on-year considering that it's so underpenetrated?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Claudia, could you repeat the second one about the insurance because we lost you in the -- there was some noise on the line?

Claudia Benavente *Santander Investment Securities Inc., Research Division - Research Analyst*

Sure, no worries. You have currently given to very few clients an insurance product, so I was wondering how much clients currently have an insurance product. And with this number, we have seen the revenues from insurance to increase by above 20% year-on-year, so I was wondering if this number can accelerate looking forward.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Yes. Also Manuel Romo, President of automobile and then the insurance with the...



Manuel Antonio Romo Villafuerte *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Payment Methods*

The credit card, no?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

And the credit card also.

Manuel Antonio Romo Villafuerte *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Payment Methods*

Manuel Romo. Let me -- Claudia, let me just probably complement what Rafael was mentioning at the beginning of the call. We expect to have the growth of the credit card portfolio between the -- around the 25% -- 20% to 25%. And really, what is happening on the business is that we are becoming more and more efficient on addressing engagement strategies with different channels of our customers. So what -- when you see a little spike on growth it's basically because of portfolio strategies and not going after new segments. This is in -- behind the scenes. What we are doing is taking care of the quality. So we are continuously increasing the quality of the new customers and the campaigns. And we have the luxury of doing that with increased response rates because we have many more mobile and alternative channels of addressing the customers. So really, in a nutshell, we expect it to be between the 20% and 25% growth looking forward.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

[Alberto]?

Unidentified Company Representative

With respect to the insurance question, I would say that, currently, more or less, the penetration in our client base is around 6%, which is quite low. So definitely, it is not a mature asset we will have looking forward. I'll see a lot of opportunities. And also, actually, we would have to develop new channels of distribution. We have to come up with new initiatives. However, we're not changing our guidance with respect to insurance this year. Please do not give those ideas to my bosses and dynamics because I am already under a lot of stress to comply with this. But you are right that there's a lot of room to grow in the future, but we have to develop these strategies, to develop these new distribution channels. And that would take some time, but we are actually working on that and very partisan on this issue.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

As you can see, [Fer Solís] is very good to me. [We share] the -- everything, the budgets.

Claudia Benavente *Santander Investment Securities Inc., Research Division - Research Analyst*

That's good. Perfect. And I have -- only have one more follow-up question. I was wondering anyways about like if we expect, for instance, an interest rate reduction or cut in second half of 2018, I'm not sure, but I would believe that maybe in the beginning, there should be a short-term benefit because of the large position in deposits. And you should benefit off lower interest rate expenses -- lower interest expenses in the short run that -- before seeing a reprice to low rate, right?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Very right, Claudia, exactly right. I mean, that's the advantage of the retail bank that you have a natural edge on the -- on those spaces. So yes, we are very confident on the upward trend. We have been able to manage that quite consistently on the right track. I think the trading guys have been doing an excellent job and also the commercial guys and the product guys. But on the -- when the interest rate starts to go down, we will be very pleased with that.

Operator

The next is Philip Finch with UBS.

Philip Finch *UBS Investment Bank, Research Division - MD, Global Banks Strategist, and Latam Banks Analyst*

Really 2 sets of questions. First is just a follow-on on the expectations for interest rates, obviously, remaining stable in the short term as Gabriel mentioning. In light of that, can you give us some color on how much higher margins could rise by, say, by the end of this year? And also looking forward to 2018, can we assume margins still going up? And if so, what are the drivers and by how much? And the second question is really going to the ROE picture where, clearly, we're seeing some robust numbers coming through. First of all, can you shed some

light on where ROEs could go up to in 2018 in light of your 2020 target of 20%? And also maybe share some views on the ROA. We talk about 20% ROEs in 2020. Where do we see ROAs in 2020? I mean, in Q2 this year, it was 1.8%. So can that go above 2%?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Philip. The first one, we are expecting around 15 basis points more, so to go to a NIM of 5.81%, around that, no, if things go like it should be let's say. And the second one about the ROE, maybe Rafa (inaudible).

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes -- no, and thank you, Philip, for the question. The ROE, as you know, we will end the year. The ROE for the quarter was very strong, was 16.4%. If we just seed on the capital that we just exchanged for the Basel II to Basel III, no, to be efficient at that, we will get, for the next year, almost a flat growth on the ROE. So we have to manage that in a way that continue an upward trend, and we don't see an issue of doing that. We will, as the year evolves, we will communicate to you the strategies on that. On the ROA, I agree with you. The ROA that we are targeting for the 2020 is 2.2%. That's the ROA that we need to achieve. What you have seen in the ROA is a continuous expansion. It's a slow one, but it's a continuous expansion of at least 10 basis points from the last quarter. So yes, we are confident to achieve that. Also, there are -- the more we move into the consumer, the better the assets delivered to us. And also, we have been very careful also on the trading book and on the -- on that part to be very efficient on the positions that we hold in order not to waste any return on that part. So I think we have everything aligned to keep growing the ROA. The ROE, maybe you will see a slow evolution in the first quarter of next year, but that will catch up in the third and in the fourth quarter of the next year. So no, we are on track. We are confident on that. As Marcos mentioned to you, if you look at the margin of the bank, already is at 5.81%. That really reflects what really the consumer book and everything that the SMEs and the commercial guys and the corporate guys are doing and also the government book. So yes, we will -- we are very confident to see additional expansion on the NIM, at least, as Marcos mentioned, to 15 more basis points.

Philip Finch *UBS Investment Bank, Research Division - MD, Global Banks Strategist, and Latam Banks Analyst*

Just on that NIM of 5.81%, should we assume this is the peak? Or can it go higher than this?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

No, it will go higher. It will go higher.

Philip Finch *UBS Investment Bank, Research Division - MD, Global Banks Strategist, and Latam Banks Analyst*

And how much higher? Do you have any estimates on that?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Not yet.

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Not yet, but it will go higher, Philip.

Operator

We'll go next to Domingos Falavina with JPMorgan.

Domingos De Toledo Piza Falavina *JP Morgan Chase & Co, Research Division - Head of Latin America Financials*

My question, I think, is more -- most of my questions are also answered. My question, I think, is more due to the fact I'm not very familiar with the Mexican system. We also noticed the NPL increase every second quarter, and I did read the explanation on the credit card. But I couldn't really figure out why this happens on the second Q. So could you just like shed some light on why exactly this happens?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you, Domingo. Good question. Maybe Manuel Romo is going to give us some help here.

Manuel Antonio Romo Villafuerte *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Payment Methods*

Yes. Really, it's because how the spend behavior goes year after year. There are extraordinary income for the people that usually happens towards the end of the year, and even though spend is very high, people usually use that excess cash to pay off debts of credit cards to have more open to buy limits so that they can buy year-end purchases. In the middle of the year, because of vacation time and back-to-school promotions, that kind of thing, spend grows, but the excess cash is not there. So what we usually see is a growth in the second part of the year in -- at the middle of the year from probably Easter time towards July and then starts coming down as spend requirements come down. And really, that's what happens.

Domingos De Toledo Piza Falavina *JP Morgan Chase & Co, Research Division - Head of Latin America Financials*

And if I may, a second one. Like, we noticed coverage ratio went up by 10%, and we noticed there were a couple of charges related to CNBV requirements. But if you were to break down the 10% coverage increase in 2 categories, one, new regulations and loan book requirement and the other one being sort of a cautious view on management given the faster growth, how would you split this additional provision?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

70% will be CNBV related.

Domingos De Toledo Piza Falavina *JP Morgan Chase & Co, Research Division - Head of Latin America Financials*

Could you repeat that, sorry?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

70% will be of that number that you mentioned will be CNBV related.

Domingos De Toledo Piza Falavina *JP Morgan Chase & Co, Research Division - Head of Latin America Financials*

And 3% (sic) [30%] would be more a caution to you going forward?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes, 30% will be caution going forward, yes.

Operator

We'll take our next question from Carlos Gomez with HSBC New York.

Carlos Gomez-Lopez *HSBC, Research Division - Senior Analyst, Latin America Financials*

You referred earlier to the possible allocation of capital to possibly dollar loans and Basel III. Could you perhaps clarify that a little bit? And second, as you mentioned, your risk-adjusted NIM for commercial and for government has gone up 30%, 40%. Your clients are paying more. Now we have not seen an effect on asset quality yet. Now at what point do you think or at what level would rates have to go so that you will start to see an increase in NPLs?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

The first one, the dollar loan, I don't know. Armando, can you give us some color on that portfolio in dollar that -- you want to increase it, no?

José Armando Rodal Espinosa *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Wholesale Banking*

Yes. My name is Armando. (inaudible) [strongly outline] in dollars these for the next 12 months between \$500 million and \$800 million for the next 12 months.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

(inaudible)



José Armando Rodal Espinosa *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Wholesale Banking*

I don't know.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

No, in terms of...

Carlos Gomez-Lopez *HSBC, Research Division - Senior Analyst, Latin America Financials*

So you're stating that is origination or that is part of the portfolio that you're thinking of buying?

José Armando Rodal Espinosa *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Wholesale Banking*

Yes, origination, origination.

Carlos Gomez-Lopez *HSBC, Research Division - Senior Analyst, Latin America Financials*

And that is because you see better spreads in dollar loans, no?

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

(inaudible) portfolio (inaudible).

José Armando Rodal Espinosa *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Wholesale Banking*

No, we think that the spreads is going to be in the same amount that is right now.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Talking about the NPLs is I don't know. We are not increasing the rates to everyone, so increase the rates where we need to increase them, no? And the peak is there. So we don't see any further increase in the NPL because the -- we are -- right now everybody, I think, agrees with me that the [7] in the rates is like, so far, the peak, no? And so we don't see an increase there in the future because we don't see an increase in the rates. So everybody's talking about the reduction in the rates in the near future. So that's it, I think, no?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes. Let me give you an example also about what Marcos mentioned. Let's go to the mortgage book that has been outstanding in growth. If you look at the NPL numbers on the mortgage book are extremely low, and the reason for that is that, basically, we are really targeting our clients. So we understand what's the behavior of those clients with us. And if they have a loan with other banks, we also understand the behavior on the credit bureau. So when we price the relationship with the client, it's not that we are just hiking for the sake of hike because we are really taking into account what's the risk-adjusted margin that we need really for each of the clients. So instead of going up and into the market and raise the prices as everybody does, you will never see that we are giving high or low prices on the mortgage book. It's based upon the client that we serve. Sometimes, if you look at the book, you say you haven't repriced the full book on the consumer. But yes, we have repriced some of the clients. And many of the clients have stayed as they were before because the profit that we are getting by the -- by keeping the rates at the level that they are and the performance of the portfolio is giving us much more money than if we just hike the rate indiscriminately to all the clients. So that's part of the process.

Carlos Gomez-Lopez *HSBC, Research Division - Senior Analyst, Latin America Financials*

Very well, but all your corporate client, their loans will be typically tied to peers, so they could rise the rate dramatically, right?

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes. The corporate, as I mentioned, if you look at the risk-adjusted margin in the corporate and the commercial and the government, that has grown at least 40%, 50% but been extremely, extremely strong. It's really on the consumers when we can be really granular because you don't adjust those by contract. You have to adjust those on a risk-adjusted basis. So that's the way we're doing that.

Carlos Gomez-Lopez HSBC, Research Division - Senior Analyst, Latin America Financials

But then it's actually on the corporates. I mean those clients have already seen that increase. In some cases, there's been easily 50%, 60%, 70% more in installments than they were before. Have you seen any particular sector start to perhaps reflect that additional expense, financial expense and taking perhaps more pressure on the energy sector? Or you have not seen any particular corporates that have started to complain?

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

No, Carlos. So far, everything is okay.

Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance

Carlos, let me explain to you exactly what happened on that part, and Armando, who's the -- who runs that business. There was a client that wanted to have MXN 600 million for a project or whatever. Now he's adjusting that to maybe MXN 350 million. So he's slowing going into the project because of the interest rates, but they are not stopping the projects. So -- and as soon as the project starts giving the returns, they start finishing the requirements that they have to on that lending part that they missed on the first tranche. So no, I mean, companies are just very, very fast to this environment, so that's why we are very happy when we see interest rates go down.

Gabriel Casillas Olvera Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis

If I could add one thing, this is Gabriel.

José Marcos Ramírez Miguel Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director

(inaudible)

Gabriel Casillas Olvera Grupo Financiero Banorte, S.A.B. de C.V. - Deputy Director General of Economic Analysis

Just let me add something that -- besides what Rafael said. There's another set of clients that -- at the beginning of the year because of the U.S. politics put some projects on hold, and now that uncertainty has not vanished but cleared away pretty much all of it. So they have started to reactivate those projects despite that interest rates are higher. And some of them have told us even that they were used to higher rates in the past, so that's another good part of it.

Operator

We'll go next to Natalia Corfield with JPMorgan.

Natalia Corfield de Melo Monteiro

My question is a follow-up on capitalization. You said you paid like \$600 million in subordinated local debt debentures. I had seen before that you had around \$840 million in subordinated Tier 2 in the local market. So my first question is like the \$600 million is all that you're paying for now. Or are you going to pay the entire \$840 million? And also, I saw decline in your liquidated assets during -- quarter-over-quarter. I would like to know what was the main driver for this decline.

Rafael Victorio Arana de la Garza Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance

The first one -- and thank you for -- because this -- what we have been paying is the \$400 million, and we are having outstanding to reach the \$600 million. That \$600 million is composed by the late note that it's put into the market many years ago. That is \$120 million more, that we will be calling that note in '20. So we are already counting that as the reduction on that part because that will -- that note will lose completely the efficiency in 2018. So the other parts, we are not -- when the call comes, yes, as you know, we always honor the calls, so we will keep on honoring the calls but when the time comes.

Ursula Margarete Wilhelm Nieto

This is Ursula. And the -- on your question about the risk-weighted assets decline, the decline is related to the risk-weighted assets related to the investment books because the credit assets did increase in line with a loan book, but the change in the market risk credit assets is where we had the decline.

Natalia Corfield de Melo Monteiro

Okay. I understood that there would be a change in your model and that would release some risk-weighted assets. Is this related to this change? Or is something different?

Ursula Margarete Wilhelm Nieto

No, the changing model that you referred to is not related to changing risk-weighted assets. It is related to the operational risk amount of money that we have to put aside to cover operational risks. We reduced the -- it is partly reflected in that. We used to follow like the standard requirement that the CNBV had in place, and we started to work on setting up our own model, which was completed and authorized by the regulator in April. So we also have a benefit on the capital ratios because of that. The benefit on the capital ratios is about 1. ...

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

100.

Ursula Margarete Wilhelm Nieto

160 basis points. And it is basically because it is a lower requirement on the operational risk side.

Natalia Corfield de Melo Monteiro

All right. But these 160 basis points, it's not -- did not materialize in this quarter, right?

Ursula Margarete Wilhelm Nieto

I mean, when you look at -- it's -- it was not in this quarter -- no, it is in this quarter because it was in April.

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes. I can -- yes, that, as Ursula mentioned, was part of the movements of capital for the quarter. We will get a relief on the operational risk, as Ursula mentioned, because we submit to the CNBV the operational risk models, and that were approved. So there was a release of 160 basis points on the capital base. And you have everything that happened on the quarter was the payment of the dividends payout that inflowed the capital because of the operational risk. So there were a lot of movements on the capital numbers. If you want, happy to provide you on a detailed basis how was the evolution of that, but that was basically the movement that happened on this quarter, an inflow coming from the operational risk reduction and the operational on the risk-weighted assets because of the positions that we hold on the book and -- but the risk-weighted assets on the risk -- on the credit side, they did rise.

Natalia Corfield de Melo Monteiro

And just to go back, like, the total amounts that you're going to pay at the end in sub debt is going to be \$600 million.

Rafael Victorio Arana de la Garza *Grupo Financiero Banorte, S.A.B. de C.V. - General Director of Operations, Administration & Finance*

Yes. Based upon this, the objective of this Tier 1 was basically to cover \$600 million that was losing efficiency on the Basel II. And that was completely renewed by Tier 1 that are fully loaded on the Basel III. So that's the number. And the remains will be used by growing the book and also to see opportunities on the -- on portfolios that we look on the market.

Operator

And at this time, we have no further questions in the queue.

José Marcos Ramírez Miguel *Grupo Financiero Banorte, S.A.B. de C.V. - CEO and Proprietary Director*

Thank you very much to everybody, and let's meet in 3 months. Let's see what happens. Thank you very much.

Operator

Again, that does conclude today's presentation. We thank you for your participation.



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