

THOMSON REUTERS

FINAL TRANSCRIPT

Q3 2016 Grupo Financiero Banorte SAB de CV Earnings Call

EVENT DATE/TIME: 10/21/2016 10:00 AM GMT



CORPORATE PARTICIPANTS

Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR*
Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*
Rafael Arana *Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO*
Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*
Manuel Romo *Grupo Financiero Banorte, S.A.B. de C.V. - MD, Products*
Carlos Martinez *Grupo Financiero Banorte SAB de CV - MD, Retail Banking*
Guillermo Chavez *Grupo Financiero Banorte, S.A.B. de C.V. - Chief Risk and Credit Officer*

CONFERENCE CALL PARTICIPANTS

Tito Labarta *Deutsche Bank - Analyst*
Carlos Macedo *Goldman Sachs - Analyst*
Carlos Rivera *Citi - Analyst*
Marcelo Telles *Credit Suisse - Analyst*
German Velasco *BBVA - Analyst*
Claudia Benavente *Santander - Analyst*
Enrique Mendoza *Actinver - Analyst*
Carlos Gomez *HSBC - Analyst*
Ernesto Gabilondo *Bank of America Merrill Lynch - Analyst*

PRESENTATION

Operator

Good day and welcome to the Banorte Third Quarter 2016 Earnings Conference. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ursula Wilhelm. Please go ahead.

Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR*

Thank you. Hello, everyone, and welcome to Grupo Financiero Banorte 2016 third quarter results. Since most of you have already seen our results, we'll take the opportunity to give you some qualitative comments on the numbers and answer questions you might have.

Presenting this morning is Marcos Ramirez, Chief Executive Officer, and with him are senior executives to support us in the Q&A session. Marcos, please go ahead.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

Good morning and thank you for your interest in Banorte. As you might have noticed, this has been a quite volatile year in global financial markets. Nevertheless [Banorte] Mexico continues to show strong growth, particularly in private consumption.

As it is shown in slide 2, this has been mainly due to the strong growth in bonds, formal employment and real wages in which workers continued to negotiate yearly increases around 4% with inflation rates below 3%. However, the solid third quarter results demonstrate the benefits of operating in a healthy economy. Moreover, policy rates hiked by 170 basis points since the end of last year which are gradually having a positive impact in [the working] but still making no harm to loan demand. The quarterly dynamics and all the operating trends are solidly moving in the right direction and we are set to deliver on the annual guidance targets that we committed for the year 2016.

On the slide 3, earnings per share of MXN1.79 grew 8% sequentially on MXN4.9 billion net profit for the quarter. Accumulated results continued to rise strongly at a 16% annual rate on solid evolution of the recurring business reflecting in an improving margin, adequate fee generation, and controlled cost of risk and expenses. The Group's main subsidiaries also posted strong earnings growth with the bank growing 14%, insurance growing 23%, the annuities company growing 58% and the leasing and factoring company growing 15%. Quarterly ROE for the Group grew 70 basis points reaching 14.1% while the bank's ROE expanded to 14.7%, which is 110 basis points versus the second quarter. This is for the bank.



On the slide 4, total revenue expanded nicely reaching a 6% sequential increase on the recurring business.

Net interest income grew 8% during the quarter beyond a 2% expansion in the loan book. [Higher pricing] of the balance sheet is already flowing through net interest income.

Income increased 3% during the period with fees from core banking activities growing 14% year on year as a result of incremental transaction volume and the higher share of consumer loans. Trading income was MXN722 million, above the MXN600 million guidance target with a solid contribution of revenue from client operations. Other income was MXN952 million, in line with the second quarter. Around 52% of it derives from the asset collection business. We also registered in this line MXN82 million of income from operating leases, which prior to the second quarter were part of the interest income.

Moving to the NIM, on the slide 5, the Group posted a strong NIM of 4.9% for the quarter, which is 35 basis points higher than the second quarter. While the balance sheet is asset sensitive, it takes several months for the different assets to react to market rates. At this point, it's fair to say that our pricing thus far comes from the rate hikes of December and February and it's associated to the floating rate investment book and the corporate, government and commercial loan books.

Deposits have also repriced. In fact, deposits react immediately to market rates, but we have been able to control the funding costs and so far it only increased 20 basis points. Consumer-related products have not adjusted prices upwards, yet in line with the market. This will likely take place, we hope, next year.

Moving now on to expenses on the slide 6, they increased 8% during the quarter. While this is the largest quarterly growth rate of the year, bear in mind that expenses are growing at an annual growth rate of 5%. And we are committed to maintain the annual expense growth in the range 4% to 6%. Expense increases are related to higher volume of transactions, higher peso expenses on dollar-denominated costs, amortizations of IT projects and variable comp on sales personnel. The cost to income ratio stood at 45.1% in the period, while higher than the prior quarter, it still is at a level where we are satisfied.

Moving to the loan book and asset quality on the slide 7, the credit portfolio expanded 2% during the quarter, but this growth rate is impacted by a decline in government loans. Excluding this book, the loan portfolio to the private sector expanded 14% year on year. We continued to see adequate loan demand both from the companies and individuals. The consumer portfolio shows strong sequential expansion across all products, reflecting our efforts to cross sell with our retail customers. The quality of the loan book continues to evolve positively and with stability.

Page -- chart 8, the non-performing loans ratio declined 10 basis points to 2.2% versus the prior quarter due to our client inaugural delinquencies and improvements in the P&L ratios of all loan books. Charge-offs also remained stable at 0.5%. The cost of risk for the quarter was 2.4% and provisions were 7% lower during the quarter on lower requirements related to loan deterioration.

Moving to other subsidiaries on the slide 9, insurance posted net income of MXN603 million in the quarter, growing 10% sequentially. While premiums declined in the quarter, this decline is related on the carryover effect of the accounting changes applied policies. Premium production this year is growing at an 8% rate excluding this effect. So, the bank assurance business continues to expand at a good pace as a result of the growth in the bank's mortgage and [order books].

As I said, the volatility in net income results of the Company are mainly attributed to the accounting changes on the life policies. AFORE's profits for the Group were MXN349 million. The annuities company posted net income of MXN137 million, 8% lower than the prior quarter on lower income on the investment book, but its earnings are 58% ahead of last year.

Moving to slide 10, on September 30, Banorte Bank issued \$500 million, 15 non-call 10 subordinated capital notes, which has well subscribed in the international market. The coupon was 5.75%. We are strengthening the capital adequacy ratio of the bank by an estimated 158 basis points and at a lower cost. We use part of the proceeds to repay a \$200 million subordinated bond that have occurred on October 13. The new note will be compared to the capital ratios of the bank as of October and therefore you will see the impact of the capital

adequacy ratio, the CAR, in the fourth quarter.

Looking ahead, a lot of people these days are thinking of the year 2017. So, we are doing the same. In this context, as usual, we will provide you with the next year's guidance in January in this conference call.

Now, I want to ask Rafael Arana to update you on a few changes that we have made to the legal structure of the Financial Group. Rafael, please go ahead.

Rafael Arana *Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO*

Thank you very much, Marcos. Good morning to everyone. We have been communicating to the market some changes that we have made to the legal structure of the Group and its subsidiaries, yet I want to summarize them to you. They require multiple regulatory approvals which we've got and we are moving now to implementation.

If you may please move to slide 11 of the conference call presentation where you will see the structure that we are presenting to you. First, the credit card SOFOM merged with Banorte Bank back in May to align all the consumer related businesses under the Bank. Then we created our new sub-holding company called Banorte Ahorro y Prevision which is a subsidiary of the Financial Group and now is the owner of Seguros Banorte and Pensiones.

Lastly, the retirement savings company Afore XXI Banorte of which we hold a 50% stake and was a subsidiary of Banorte Bank now has become a subsidiary of Banorte Seguros through the new sub-holding Banorte Futuro. The objective of this organization is to align the legal structure to a similar structure by which the different businesses are managed and evaluated. There are no effects at the consolidated holding company arising from this reorganization.

With this we conclude and open the microphone to questions. Thank you very much.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Ernesto Gabilondo, Bank of America Merrill Lynch.

Ernesto Gabilondo *Bank of America Merrill Lynch - Analyst*

Good morning, Marcos and congrats on your results. I have a couple of questions. In the other income line, can we say it was recurring income and how much can we expect the quarter on this line? On my second question, I would like to ask you about your point of view on the recent increase in interest rates given that it was 175 basis points in less than 12 months and from levels of 3%. Do you think that this could have an impact in loan growth or in asset quality next year? Can you share your thoughts on this for the industry and for Banorte? And which are the advantages of Banorte against competitors from a potential economic slowdown? Thank you.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

Ernesto, the recurring income will continue to be a steady growth as has been happening in the past. As you know since we start pricing the relationship with the clients on a usage basis and based upon the profitability of the client, we continue to see a continuous steady growth of that. This year recurring revenues will be around 28% growth year on year and we really think that's a sustainable pace of growth for us. So, we don't see anything that can really reduce the rate of growth with the fee income growing nicely and everything that is related to recurring earning right on what we expect with that.

The next one was the impact of interest rate on the loan growth.

Ernesto Gabilondo *Bank of America Merrill Lynch - Analyst*

Correct.

Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*

Hi, Ernesto. This is Gabriel Casillas, Chief Economist. In order to answer the question of the recent increase in interest rate, I mean we've done some research -- historical research with real interest rates. So, in this context, as rates are in historical lows, it's going to take at least more or less like 300 basis points more of rate hikes to have -- to start -- to have some impact on non-performing loans and loan growth. So, in this context, we are not concerned about the 175 basis points so far.

And with respect to your question of competitive advantage Banorte, I'm going to go to the second part of that question with respect to the potential slowdown. We were already expecting a slowdown in the second half of the year in the economy, mainly due to the very significant government budget cuts. Remember that this year the government has conducted three budget cuts, 0.5% at the beginning of the year, then 0.7% of GDP in February and then 0.2% in June. And actually they have been quite fast and implemented these budget cuts. In this context, well, this has implied a slowdown in the economy -- in the overall economy.

However, if you take a look to private consumption, to retail sales, they continue to grow at a good pace mainly because of what Marcos said at the beginning of the call, because formal employment continues to increase and because real wages have continued to increase as well. So in this context, given that this overall economy is more because of the government budget cuts and the rest of the economy continues to do well, we are not quite concerned of that.

Moreover, for year 2017 we are expecting a slightly higher growth of economy mainly due to two things. One, because manufacturing, as you know, in the US manufacturing and production might have grown 0% this year and more or less everybody is expecting to grow between 1.5% and 2% next year. In this context, we believe that this will help the export sector in Mexico. And on the domestic demand one important thing is that the government -- I mean, yesterday, as you know, the Congress in Mexico approved the revenue part of the budget. And in this context it seems that -- I mean everything else is going to be approved in line with what the Ministry of Finance said.

Having said this, the budget cut that the government is proposing to do next year of MXN240 billion, actually a lot of it has been done this year already. So you will have out of that only a budget cut of around MXN76 billion. So less risk on consolidation and better improvement in manufacturing in the US, these two things might actually help the Mexican economy to grow a little bit more compared to this year. For this year we are expecting a 2% growth in GDP and for next year, 2.3%. I hope I have answered your questions, Ernesto.

Ernesto Gabilondo *Bank of America Merrill Lynch - Analyst*

Yes, thank you very much, Gabriel.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

On the next one, Ernesto, that you mentioned, the slowdown, as you know we have been very careful on the loan growth. There have been also at a point of time some concerns whether they were -- looking at our competitors that they were growing at a much faster pace. But we really anticipate since the beginning of the year and the guidance that we feel comfortable growing at a rate of pace from 11% to 13% with emphasis on the consumer book.

As you have seen, we have really reinstated a pretty good growth in commercial and corporate. Also the SME book is growing again at 8% on a very healthy basis. So we feel confident and all our projections are for the long run, to the 2020 we are really expecting loan growth around 11% to 13%. We have never anticipated any exponential or aggressive growth on the book. So we feel that at this pace we can really control the cost of risk and we can control the NPL formation and produce strong profits for the bank.

So we don't see anything. And as Gabriel mentioned, we continue to see a steady pace also in GDP, so nothing spectacular. But I think very



predictable 2.1%, 2.2% and that's why we really set up all the loan growth and all the expectations for growth on the loan book.

Operator

Tito Labarta, Deutsche Bank.

Tito Labarta Deutsche Bank - Analyst

Thank you for the call. A couple of questions also. Just first on the margins, you mentioned you've benefited from the increase in rates, but you haven't fully reflected the September hike. So, just want to get a sense how much more room is there for further margin expansion from the increase in rates and also from the shifting loan mix, if you can give some more color on that?

And then my second question in terms of asset quality, we saw a slight improvement this quarter. Do you think there could be further improvements in terms of NPLs going forward and what would that mean then for the cost of risk? Could it come down from these levels or are you comfortable with this 2.3%, 2.4% cost of risk? Thank you.

Gabriel Casillas Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis

Tito, good morning. On the margin as we stated on the note, we will continue to see an expansion of the margin because what you really see now is the effect that happened on the hike that happened in past December and January. So, yes, we will continue to see an expansion of the margin. We already took the hit on the 20 basis points that Marcos mentioned on the cost of funds. But the growth in demand deposits and the mix continues to be very, very strong and healthy. So, we continue to see an expansion on the margin for the remaining of the year and continue to be on the next year. As the effect as you well said hike rates and also because of the mix and the cost of funds.

On the asset quality, yes, you will continue to see that as we mentioned in the second quarter conference that usually credit cards peak in the second quarter because it's basically when people comes back from vacation and they fill the cards. Now, they start to really pay again and get ready for the holiday season. So, you will continue to see a slight improvement on the credit cards. And everything else compared on the commercial, on the SME, on the corporate we'll continue to do well. As you can see, the mortgage book continued to be extremely healthy and on the same the car loans. So, we haven't seen any -- we are very vigilant on the payroll as we have mentioned to you in previous calls, but that's stabilizing and really the origination is performing better than the former vintages. So, yes, we see that on the NPL and NPL formation we will see an improvement and the cost of risk we feel comfortable to staying at 2.2% to 2.4%, that's where we think the cost of risk will stay.

Tito Labarta Deutsche Bank - Analyst

That was very helpful. Just one follow-up on the margins, just in terms of trying to quantify how much more upside, another 10 basis points to 20 basis points do you think is reasonable or could it be even more than that, given that (multiple speakers)?

Rafael Arana Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO

I would say that from 15 basis points to 20 basis points is a reasonable number.

Operator

Carlos Macedo, Goldman Sachs.

Carlos Macedo Goldman Sachs - Analyst

A couple of questions here. One is a follow-up from the Ernesto's call. I appreciate the fact -- and also Tito's. I appreciate the fact that you have been very conservative and diligent in monitoring your asset quality and that your growth, for that reason, has not been exponential as

you said. But your competitors have been growing at a very fast pace and the economy at the margin is slowing for the consumer. Consumer confidence is lower, consumer expenditures have declined for two consecutive quarters. So my question is given the setup, if your competitors start seeing weaker asset quality, could there be any contagion, even though you have been conservative given that many of your clients have accounts in other banks as you mentioned before?

Second question is a little bit more specific. Looking at your funding, the money market deposits declined significantly this quarter and the third party deposits increased significantly roughly by the same amount. Could you comment a little bit about the strategy there and really what these third-party deposits are? Thanks.

Rafael Arana Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO

Let me go -- as you mentioned on the contamination potential, that's always true. But as you know, the information that we currently have from the Credit Bureau allow us to really monitor the performance or behavior of our clients with us and our clients with other banks. So, we are very vigilant and we are very, very careful on that part that happened. Yes, we are monitoring that and we will react immediately when we see and start seeing some deterioration there. We haven't seen anything on the origination front. The origination front is performing better than in the other bank business as I mentioned before.

So, the other point that you mentioned about the funding piece, remember that we have been growing the deposit book at a faster pace than the loan book. So, that has allowed us to really reduce some of the expensive deposit accounts that we had in the past. That number was close to MXN9 billion. That will reduce because it was convenient for us to really go and convert that into a cheaper deposit base. That should also allow us to really weather the increase by the interest rate hike of 20 basis points because we really reduced the exposure that we have to higher interest deposit that we had in the past. That was close to MXN9 billion as you well noted.

Carlos Macedo Goldman Sachs - Analyst

Actually the number is closer to MXN25 billion. I'm just wondering -- because it looks like you migrated from one line to the other. Just trying to understand if that's the case or if this is just a more strategic or if it just is a coincidence.

Rafael Arana Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO

No -- yes, I will comment about this and let me just transfer this to Manuel Romo, the Head of Products. He will continue to explain you the MXN9 billion plus the remains of what you mentioned about the [MXN11 million] more.

Manuel Romo Grupo Financiero Banorte, S.A.B. de C.V. - MD, Products

Yes, thank you, Rafael. Carlos, good morning. The driver behind this is a clear strategy in which we are switching the efforts, the commercial efforts of the retail bank towards cheaper funding. So, the money market piece is no longer being one of the premier products that is being marketed throughout all the segments of the individual. We are focusing on cheaper cost of funding and that is part of the value proposition that we're really changing into the markets.

That's why you see a higher growth into the low cost of funding DDA investment funds, that kind of thing and lower growth into the money market, which is basically focused into corporate and wholesale customers. That's basically the driver behind it. As Rafael was mentioning as much as we can focus there we're having great growth, great results and financial results at the cost of funding.

Rafael Arana Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO

(multiple speakers) consumer confidence also.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

But did you have another question please?

Carlos Macedo *Goldman Sachs - Analyst*

No, just trying to understand so that third-party deposits are just -- instead of money market, it's almost as if they were assets under management than an asset manager, right?

Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR*

That's right. Those third-party deposits are assets under management.

Carlos Macedo *Goldman Sachs - Analyst*

Okay.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

Yes, probably that was so at the network. We, as Manuel said, we switched that into investment funds and chit funding and we've been quite successful in that.

Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*

And as Marcos was saying, Carlos, I would like to add -- this is Gabriel Casillas -- I would like to add something about consumer confidence. Two things; on the one hand, you know that the correlation between consumer confidence and retail sales or private consumption, more hard data, it's very low. I mean, it's very difficult to make an assessment between one and the other, either a contemporaneous time or even with lags.

Now having said this, on the other hand, you have the purchasing power component of that consumer confidence that this is the one that holds some correlation with some lags with the hard data. This has been used in the past like before 2006 all held at very high correlation with exchange rates and then later on correlation with exchange rate was lost and actually it was highly correlated with inflation. What interesting happening lately is that since the exchange rate has reacted so violently in the people's minds now the exchange rate has become once again a part of their concerns. So because of this and the US election, we think that consumer confidence has been suffering.

However, we do think that as we have seen a very low pass-through from the exchange rate inflation that we will get back to have these high correlation between the purchasing power and inflation and a very low correlation with the exchange rate and consumer confidence will improve. However, as I said, it's very difficult to have -- to assess any sort of [causality] between consumer confidence and the hard data. I think it's better to take a look to formal employment or real wage increase to really have a better view on what's been happening in private consumption.

Carlos Macedo *Goldman Sachs - Analyst*

Just one final follow-up, going back to this question. If one of your competitors, given that information flowed so well, if one of your competitors, (inaudible) were to go past due, and it will be one of your clients with loans with you, but it would still -- the client would still be current with due, would you have to provision for that client or would you wait until that client went past due with you to provision, even though the client has already past due with one of your competitors?

Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*

No, it's with you.

Carlos Macedo *Goldman Sachs - Analyst*

Okay, so there could be a --

Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*

And depending on the product on the other side, but basically it's with you. But that's why you have to monitor and vigilant your clients with you and your clients with other banks on a permanent basis. And in some cases you have to reserve based upon the product and the rules.

Carlos Macedo *Goldman Sachs - Analyst*

Okay, but there wouldn't be any preventive provisions?

Gabriel Casillas *Grupo Financiero Banorte, S.A.B. de C.V. - MD Economic Analysis*

No, preventive provisions, no, as you know we cannot do any general provisions. It has to be a specific.

Carlos Macedo *Goldman Sachs - Analyst*

Okay, all right, perfect. Thank you so much.

Operator

Carlos Rivera, Citi.

Carlos Rivera *Citi - Analyst*

Thanks for the opportunity to ask questions. My first question is regarding credit cards which are growing significantly this quarter. This is very important because this segment had been lagging on the consumer book. So just wondering if you could give us a little bit more color here, what is driving this and if we can expect this high pace to be sustained in the coming quarters?

I remember that Manuel Romo mentioned last time the introduction of cash back product. So wondering if this is helping here and again if the credit card can be catching up with the high levels that we're seeing on other products such as car loans and payroll?

And my second question is related to expenses. We're seeing a strong growth quarter over quarter on this line, mainly driven by personnel. How should we think about expenses for the fourth quarter because they tend to be stronger in the fourth. So just wondering what are the implications for the guidance. Of course, up to now the year-to-year is within the guidance. But if we are seeing the typical seasonality of the fourth quarter OpEx for the full year could end up on the high end of this guidance. Thank you.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

I will start with the expenses. We are committed to at the end of the year clearly between 4% to 6% and we are not moving up that. You see an increase but we will decrease it and we are managing the whole year instead of the quarter. So you will see that for the whole year is normally between 4% and 6% and that's our commitment. And now let me pass to Manuel Romo to add color on the credit card.



Manuel Romo *Grupo Financiero Banorte, S.A.B. de C.V. - MD, Products*

Yes. Thank you, Marcos. Carlos really the driver behind the growth that you are seeing is mostly purchases. The strategy -- purchases and the new product that you mentioned. We launched a new cash-back product, the only cash-back -- full cash back product in the Mexican market and it has been growing very nicely. We are probably around 100,000, 150,000 accounts in that product and really the behavior of the consumer is very nice. But in the overall portfolio the growth that you're seeing is mostly because of promotions, efforts to be more attractive and drive POS purchases.

What we are seeing in the market right now is that also the sales growth is being very healthy. There is a higher number of transactor customers, so people that pay higher percentage of their balances. The portfolio -- that's why you see that the portfolio is behaving very nicely in quality. Sales are growing very nicely in both markets. But the growth of the portfolio in assets is not being as fast as in the past couple of years. So, the strategy behind this is just make the product more attractive to use it, be careful about cash driving the balances and that's basically what we will continue doing.

Operator

Marcelo Telles, Credit Suisse.

Marcelo Telles *Credit Suisse - Analyst*

Congratulations on the results. I have a couple of questions. I think the first one is more specific one. What was the impact of the FX depreciation in your cost base and also on your fee expenses, because when you look in terms of the currency, I think it depreciated roughly 6% during the third quarter and we're already seeing a depreciation so far of something close to 4%. So, has the depreciation impacted your cost base in some way and could the currency appreciation in the fourth quarter help your OpEx and fee expenses?

And my other question is if you could comment on the -- I think you've done the rollout of the -- into your ATMs, I think you guys are selling products through the ATMs. I remember that was something that was supposed to happen during July. Are you able to sell through all your ATM network? Is that really working the way you guys were expecting because this could be an important source of additional credit growth and fee generation?

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

Starting with your second question, we are in an embryonic phase, I will say. So, we are starting to sell our insurance and all these into ATMs, and maybe you can give us some color.

Manuel Romo *Grupo Financiero Banorte, S.A.B. de C.V. - MD, Products*

Sure. Thank you, Marcos. This is Manuel again -- Marcelo Romo again. Marcelo, the strategy is basically a gradual deployment of the functionalities to do multi-vendor sales and engaging throughout the nation. Basically, we're focusing on higher transit ATM with the right population and the right segments. Now, we expect to finish that, as Rafael mentioned, a couple of calls ago according to plan. And really the products that we are selling is right now we're mixing and learning through analytics which is the highest result, highest response rate. So far we have done, as Marcos was mentioning, insurance. We have done some testing credit cards activation line increases, we have done personal loans and payroll loans and the results have been great because honestly customers are loving to have the bank easier and simpler to operate. Obviously this in a learning phase because we are finding which is the right mix of pre-approved customer to send out to ATMs, which is the right mix of in which ATMs you need to do insurance, in which credit, et cetera. But so far the results have been great. So in a nutshell what we are doing is stabilizing the rollout of the functionality of the multi-vendor functionality nationwide, we will do it as planned. And second, as we do that we will learn to be more efficient in doing the analytics and all the segmentation to send this offers to customers.

Ursula Wilhelm Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR

Regarding your question about the FX impact on expenses, it's difficult to give you a specific number as to how much is related to FX, but for example in this quarter, we see an increase of about 3% in expenses that are related to the use of software and licensing which are dollar denominated. Another example is also on the IT front. Amortization of projects in IT, some of them are also denominated in dollars and they went up by about 3% the expense during the quarter. And then there are also that are related to transactionality especially in the POS and credit card businesses where we pay the fees that we pay to the credit card companies are dollar denominated. Here the growth in the quarter is larger partly because of volume, but partly because of FX.

Marcelo Telles Credit Suisse - Analyst

I see. Thank you, Ursula. Just one final question if I may. We also saw an increase in the acquisition costs of the insurance business which also explains part of the big jump in fee expenses -- sorry, in the OpEx. And how should we think about it going forward? I mean, is the market turning more competitive, is it becoming more expensive to sell insurance or is there something like isolated that you could see reverse of that in future?

Ursula Wilhelm Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR

The increase in the insurance sector the acquisition cost is really not that the acquisition cost is running higher than we expected, it's just that in the accounting when you see the number in that line in addition to the acquisition cost, it also includes the fees that we'll get from the reinsurers based on the reinsurance, the contract that we give them on reinsurance. And if you look at the premiums and if you look at the reinsurer, we have been using less reinsurance because we have been getting out of the largest P&C businesses that you typically reinsure.

So, we have received a lower amount of fees from the reinsurance and that is why the acquisition cost seems like it's going higher, but it's because of the other effect.

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

Right. And I will add that -- I mean typically in this market, where we see some competition is not in the front of the acquisition costs. At least that's not what has been happening in the Mexican market. Mainly where you see competition is in the premium side and I have nothing else to add to what just Ursula mentioned.

Operator

German Velasco, BBVA.

German Velasco BBVA - Analyst

Thanks for the call. I have one question and it's regarding with the consumer performance. We have seen a lot of contrary signs about the consumer performance in the economy. As you mentioned, we have seen that the product consumption is performing well, but at the same time we are seeing that consumer confidence is decreasing as well as inflation ratio is hiking and also the interest rates. So, can you share with us your thoughts about what do you expect for the industry in the next year for the consumer loan growth and specifically for Banorte?

And in the same line, we have seen that Banamex is coming back to the market and I think it is an important competitor in the consumer loan. So, what do you expect about Banamex coming to the market and whether you expect for consumer loan growth for the next year?
Thanks.

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

Let me start and then I pass it on. I think it's quite important to understand the Mexican market. What you see is that the large banks, the CD, Banamex, BBVA, Santander, ourselves, we have enough scale inside our client base to really see the potential growth on a steady basis without

going aggressive into the market and poach clients from one to the other. I think that has been the strategy of Banorte and we will continue to do so. So, if we were really looking into an open market, I think that it will be difficult for us to predict the loan growth that we mentioned at the beginning of our 11% to 12% overall loan book. But we will continue to see pretty strong opportunities on the payroll book, to penetrate the payroll book. As Manuel mentioned, credit cards continue to be more attractive to our clients, more and more, and we penetrate our client base.

Car loans continue to be strong and we basically work with the clients that we have. So when we look and we set up the numbers for the budget, we don't think on an open market poaching strategy. So, we really concentrate on what's the pace that we can build the book based upon the clients that we have and the information that is secure and really moving a lot more of pre-authorized credits more and more, instead of being open into new entrants into the book. So that's where we continue to see good growth. The numbers that we mentioned in the past nothing spectacular, but steady and safe.

So that's what we see and we continue to be -- as you know, everybody talks about consumer confidence, but if you look at our retailers, retailers continue to be sound and safe, and auto sales, car loans continue to grow, employment continue to be steady. We monitor that very closely because of the number of payrolls that we have and how active those accounts are.

So, we continue to be confident that we can grow at the pace that we have mentioned in the past two years, and that allow us to really produce the results that are predictable to the market and steady to the market and safe to the market.

German Velasco BBVA - Analyst

Okay, Rafael. Thanks a lot. What are your feelings about the sector as a whole for the next year regarding the consumer loan growth? Do you think it's sustainable for Mexican banks to continue increasing at double-digit rates?

Rafael Arana Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO

I think the case would be who has the better analytics and who has the better credit trade risk potential. I think it's a matter of -- because you know the client, you have the information about the client with you and with the other banks. So, it's really basically how good the analytics and how good your value proposition is that the customers stays with you. So I think it's going to be a much more, I would say, a competition about really putting a lot more value into the client hands and going deep into the analytics proposals to really make each of the clients a different proposal based upon his risk, the loyalty to the bank and the potential value that the client has with us.

Operator

Claudia Benavente, Santander.

Claudia Benavente Santander - Analyst

Just had two questions. The (technical difficulty) the waiver extending the period of which PEMEX suppliers should (technical difficulty) of course if their performance deteriorates. How has been the performance for this group so far on your book?

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

Claudia, could you please -- because there is a lot of noise on the static, on the call. Could you repeat the question to us please?

Claudia Benavente Santander - Analyst

Sure, of course. (inaudible) to the waiver where they extended the period on which PEMEX suppliers should be incorporated on the NPL portfolio (technical difficulty). I was wondering how has been the performance with PEMEX suppliers on your portfolio in particular. I mean, how you have seen this book so far, it seems for me that sort of given this waiver it's kind of a way of regulated fee this sector may be

to start deteriorating right?

Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR*

No. Hi, Claudia. It's Ursula. The waiver that you mentioned is not to the supplier. It's loans to individuals, mainly consumer loans that are in the areas where PEMEX has its operation. If the individual wants to, because it's having difficulty to pay or has lost his job of anything, the person can come to the bank in which it has the debt and the bank can restructure the loan with some facilities under reserving fees. This is something that -- it is the regulation is clearly we have disclosed in our quarterly release what the regulation is about and we also have disclosed that we have -- at this quarter, we have no outstanding debt that has been restructured on under this provision.

Claudia Benavente *Santander - Analyst*

Okay, great. Thank you. And my second question is regarding the government book. It seems like the loan growth (technical difficulty) this year. I was wondering what are you expecting for next year since (technical difficulty) financial discipline law is going to be enacted at the beginning of 2017, [However] several opportunities are going to be introduced. So I was wondering how you feel about the growth in that segment? Thank you.

Carlos Martinez *Grupo Financiero Banorte SAB de CV - MD, Retail Banking*

Hi, Claudia, this is Carlos Martinez, Head of Retail Banking. Regarding government portfolio, we feel very confident the way we are at the moment. We don't expect a big growth in government portfolio. We've been growing for the past two years. This year is going to be more in the line between 3% and 5% growth year to year and we expect next year to be growing in a pace next to 10%, but not more.

And I would say exactly we (inaudible) and only two clients and the decrease is there. So, we are moving in the right direction. And next year we will recover these client, but business as usual. So, it should be around 10% as we said.

Operator

Enrique Mendoza, Actinver.

Enrique Mendoza *Actinver - Analyst*

Thank you for taking my questions. I have four questions, if I may. The first one is related to the fast pace of deposit growth in demand deposits in the non-interest-bearing deposits. How can it be explained and how can it be sustained in coming quarters? And my second question is related to the increase in Solida's project. If you could give us a further disclosure about those projects.

My third question is related to the increase in the expected loss and the non-expected loss. And my fourth question is related to the tax effect, increase in the personnel expenses in the quarter. Could you bring us more color about those features?

Manuel Romo *Grupo Financiero Banorte, S.A.B. de C.V. - MD, Products*

Yes, Enrique, this is Manuel Romo. Regarding the deposit growth, what we are -- in the past years, what we have worked a lot on is on the quality of the new accounts of deposits and we are being more focused regarding specific individual new accounts which is the minimum balance and that's number one, regarding the quality of deposit. We're being stricter not just to open new accounts, but to open better accounts. Now, that is coupled with the strategy of segmentation and pricing that we have been executing in the past 18 months in up-scale segment, the preferred segment, (inaudible) segment and this year we did that in the personal segment.

The strategy basically weighs the fee of an account depending on the average balance and number two number of transactions of the debit card. That has brought a lot of quality and higher balances, probably between 10% and 15% higher balances on our DDA -- our deposit accounts. So, really when you multiply that times the number of customers that we have in those segments, the results have been very, very



good. So, in a nutshell, it's more transaction, better pricing, which is pricing aimed at increasing average balances, that's basically the strategy.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

The second one is about the Solida pieces. You will continue to see that number move in the next quarters, because as you know Solida used to invest in projects and those companies were on a standby basis. So, now that those companies are coming alive, this project starts to move and Solida becomes again active in those projects that have been restarted. So, you will continue to see some movement in that numbers in the coming quarters.

The next one is expected loss. Could you be more specific about what you want to know about the expected loss and non-expected loss?

Enrique Mendoza *Actinver - Analyst*

Of course. Although the loan portfolio has been accelerating recently, we have seen healthy asset quality figures about the non-performing loans index and cost of risk. However, the ratio of expected loss and non-expected loss have been increasing slightly. And I don't even know if it is more related broadly to mix or if you see higher risks in each of the product line. Could you elaborate more about those?

Rafael Arana *Grupo Financiero Banorte, S.A.B. de C.V. - CFO/COO*

Yes, let me start and I will ask Guillermo to complement. It's related -- remember that based upon the expected loss methodology that there has been the -- also remember there was a change in the waiting process on the credit cards at the beginning of the year. So that's related to a high growth portfolio. It's also related of the mix. To be honest, we haven't seen anything different of what we expect on the -- that's why we continue to be confident about the cost of risk that we produce to the market. But Guillermo has -- if you want to complement on that a bit?

Guillermo Chavez *Grupo Financiero Banorte, S.A.B. de C.V. - Chief Risk and Credit Officer*

Sure. Basically we expect for Banorte that our -- excuse me, maybe I am too far from the mic -- the expected loss is 2.3% and un-expected loss is 3.4%. Both are a consequence of the growth in loan book. Before they were 2.2% and 3.4% in the last -- in the second Q of 2016. And as we grow our portfolio, these numbers kind of tried to run in parallel at different levels, but basically the equity we are using for the non-expected loss has been growing and therefore we have the risk profile and risk definition on how our portfolio is performing.

Enrique Mendoza *Actinver - Analyst*

Then if it is something recurring that we can continue to see in next quarters, those increases in expected and non-expected loss could bring higher cost of risk?

Guillermo Chavez *Grupo Financiero Banorte, S.A.B. de C.V. - Chief Risk and Credit Officer*

Basically they will be reflecting a portfolio growth. With every new loan that you give, you need to quantify the amount of expected loss that is embedded in the product you are looking. And also it has a non-expected loss piece that you cannot just do one. You have to do both for every portfolio and for every loan you make in that portfolio.

Enrique Mendoza *Actinver - Analyst*

Therefore if the expected loss is increasing the fear to cost of risk could also be increasing?

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

No, I think what Guillermo mentioned is that's why we set up the loan book growth at the pace that if we exceed the pace of the loan book, then you will see a higher expected loss because of the provision methodology that's due to unexpected loss. If we stay at the levels of growth that we have seen that cost of risk will stay where we are seeing 2.2% to 2.4%. If we accelerate the loan book and the loan growth then we have to change the expected loss and the non-expected loss because based upon the mix and the loan growth then you have a different number. But the numbers that we provide to the market are the numbers based upon the loan growth that we currently have.

Enrique Mendoza *Actinver - Analyst*

Okay. Thank you.

Marcos Ramirez *Grupo Financiero Banorte, S.A.B. de C.V. - CEO*

The other part is you said about the tax effect, could you please specifically read what part of the tax effect?

Enrique Mendoza *Actinver - Analyst*

Yes, in the personnel expenses, in the sales, general, and administrative expenses there have been an increase and some of the increase is explained in the earnings press release as something related with taxes or contributions related with the salaries of the employees or at least that's what I --

Ursula Wilhelm *Grupo Financiero Banorte, S.A.B. de C.V. - Executive Director of IR*

Yes, it's related to the social security and tax contributions that we have to make to the tax authority based upon the personnel expenses that we have. It's just that for the quarter they were larger than the previous quarters, but they are within, say, the annual expenses that we expect to have on personnel. It's nothing really out of the ordinary.

Operator

Carlos Gomez, HSBC.

Carlos Gomez *HSBC - Analyst*

Congratulations on the results. Two questions, the first one is if you can give us the guidance for your expected tax rate for the coming year, 2017-2018? Second, I want to ask you about your subordinated debt issuance that you did this quarter, you got a price of 5.75%, did you swap that back into peso and so at what rate or did you keep it in US dollars? And if you need to -- if you did what we should expect in terms of subordinated debt for now or you expect to continuing on issuing in the future? Thank you.

Carlos Martinez *Grupo Financiero Banorte SAB de CV - MD, Retail Banking*

First, the guidance on tax ratio, we will give you the full guidance in next conference in January, but we are aiming to close to 30%. We're not playing in there. So you will see a 30% tax guidance. The bonds that we issue to the market stays in dollars.

Carlos Gomez *HSBC - Analyst*

So, this will be a dollar liability at 5.75% over next 10 years until it is callable, right?



Carlos Martinez Grupo Financiero Banorte SAB de CV - MD, Retail Banking

Exactly right.

Carlos Gomez HSBC - Analyst

Okay. And on the tax rate, so again there is nothing in the current fiscal proposals that may give in that your tax rate is going to deviate significantly one way or another, 30% is what you think you can attain in the next couple of years?

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

Yes, right. Sometimes, it ranges from 29% to 30%, but that's the range that we think is going to happen.

Carlos Gomez HSBC - Analyst

All right. Thank you for that. (inaudible) us about your US business, any update on your Texas bank?

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

The Texas bank is fully operational, it's performing well. There has been real interest from many people about it and we as always look at the best deals for our investors. When we have information, we will release that to you immediately.

Operator

And at this time, we have no further questions in the queue. I'll turn the conference back over to management for any closing remarks.

Marcos Ramirez Grupo Financiero Banorte, S.A.B. de C.V. - CEO

Well, thank you very much and see you next year, I hope, with good news for all of us and for you and thank you.

Operator

And that does conclude today's conference. Again, thank you for your participation.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Briefs are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT BRIEFS REFLECTS THOMSON REUTERS'S SUBJECTIVE CONDENSED PARAPHRASE OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT BRIEF. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017 Thomson Reuters. All Rights Reserved.

