GRUPO FINANCIERO SANTANDER MEXICO, S.A.B. DE C.V.
TRANSCRIPT FIRST QUARTER 2015 EARNINGS CONFERENCE CALL
TUESDAY, APRIL 28, 2015
10 AM US ET, 9 AM MEXICO CITY TIME

Operator:

Good day everyone and welcome to Grupo Financiero Santander Mexico's First Quarter 2015 Earnings conference call. Today's call is being recorded, and after the speakers' remarks, there will be a question and answer session where if you'd like to, you may ask a question. You can do so by pressing star, one on your telephone keypad, and if you are on a speakerphone, please pick up your handset before signaling for a question. Again, that is star, one for questions.

For opening remarks and introductions, I'd like to turn the call over to Mr. Hector Chavez, Managing Director, Head of Investor Relations. Please go ahead, sir.

Hector Chavez, Managing Director, Head of Investor Relations:

Thank you. Good morning and welcome to our first quarter 2015 earnings conference call. We very much appreciate everyone's participation. By now, everyone should have access to our earnings press release and the Company's presentation, which were released this morning before the market opened. Speaking during the call will be Marcos Martinez Gavica, Executive President and Chief Executive Officer. Also joining us are Pedro Moreno, Deputy President of Administration and Finance, and Rodrigo Brand, Deputy General Director of Public Affairs and Communications, all of whom will be able to answer questions during the Q&A session.

Before we being our formal remarks, let me remind you that certain statements made during the course of our discussion today may constitute forward-looking statements, which are based on Management's current expectations and beliefs and are subject to a number of risks and uncertainties that could cause actual results to differ materially, including factors that may be beyond the Company's control. For an explanation of these risks, please refer to our filings with the Securities and Exchange Commission and the Mexican Stock Exchange.

On today's call, Marcos will provide an overview of our performance this quarter, including a review of Mexico's macro and financial system trends. Marcos, please go ahead.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Thank you, Hector. Good morning and good afternoon for the people who are in Europe, and thank you for joining us on this earnings call. This, commercially speaking was a good quarter. We reported strong loan growth while maintaining our focus on asset quality. We expanded our loan book by 16% year-on-year, exceeding market growth rates and achieving a positive performance across all segments, particularly in our portfolio SMEs, mortgages, and middle-market.

Consumer loans also reported strong growth but were affected by ongoing softness in credit cards. Growth of our deposit base was also strong, up 14% year-on-year, and in particular, demand deposits for individuals increased by 23% year-on-year. This was achieved while improving NPL ratios and reducing cost of risk on a sequential basis. In terms of efficiency, as anticipated, operating expenses in the quarter reflect a higher branch base and the impact from the deposit insurance fee. And I will provide more details about this in a few minutes.

As you know, we are also close to finalizing our expansion plan with a total of 194 new branches opened since the fourth quarter of 2012 and the last few branches planned to be open before the end of the second quarter of this year. This quarter, we also completed acquisition of the 3.2 billion peso consumer loan portfolio from Scotiabank, as announced last November. The more than 39,000 loans acquired were effectively added to our portfolio as of April and will increase our share in the personal loans core segment by approximately 2,030 basis points.

On the next page, in terms of the macro, we see consistent evidence of economic recovery. Even though the manufacturing industry showed a slight slowdown in the first quarter of the year, we expect an improvement in performance going forward as economic activity in the US accelerates in the coming months. At the same time, we continue a recovery in our formal employment and higher real salaries have started to translate into more robust consumer spending indicators. For example, retail sales as measured by Antad increased by 5.7% year-on-year in the first quarter of 2015, accelerating from 1.9% in the fourth quarter of last year. In addition, domestic car sales also also accelerated in the first quarter of 2015, expanding 22% year-on-year. So while we remain cautious about the strength of the consumer, these recent indicators allow us to be optimistic about the future.

We maintain our GDP growth estimate of 3.2% for 2015 and expect GDP growth of 3.8% in 2016 as the continuous strength of the US market continues to drive the Mexican manufacturing sector. This forecast already considers the impact of recently announced budgetary cuts for 2016 announced by the government early this month. We also see interest rates increasing to 3.5% in the second half of the year and 4.5% in 2016, with inflation declining to 3.2% this year and rising slightly to 3.5% next year.

Moving to the financial system, as anticipated, we continue to see positive signs of recovery in loan growth during the quarter, following the pick-up that began last November. Total system loans rose 10.9% year-on-year in February, the most recent public data. All segments posted positive performance except credit cards, which continued to decelerate during the quarter, and actually, including credit cards, consumer loans for the system rose 9% year-on-year. We expect overall lending activity to maintain this positive trend as the economy continues to recover.

The system in terms of deposits is also performing well, up 11.7% and continuing the upward trend shown since the third quarter of last year. In this context, Santander Mexico expanded our total portfolio - loan portfolio - by 16% year-on-year, with both retail and corporate loans posting a strong performance. Retail loans were up 16% while corporate rose 16%, continuing the pick-up seen last quarter. Our strategic focus on our core market has allowed us to increase the share of this segment in our total loan portfolio since our IPO in the third quarter of 2012.

As you can see in the pie charts at the bottom on the right, SME rose 9% to 12% and mortgages from 20 to 23%, and while consumer loans, including credit cards, remained a key segment in our strategy, the share fell from 18 to 16%, reflecting the weakness in the Mexican consumer over the last two years. Looking ahead, we should see these segments increasing share of our business following the trends we began to see during the past two quarters.

Now moving to individual loans, we grew our portfolio by 13% year-on-year, beating market rates across all segments. Mortgage loans, our largest individual product, continued to report strong volume growth, up 15% year-on-year. We continue to expand significantly our market while leveraging our wide product offering and remain a leading mortgage originator in the country. Most importantly, consumer loans, including credit cards rose 20% year-on-year, more than doubling market growth from 9%. This was driven by our renewed focus on payroll loans after improving our processes and by continued growth in personal loans. Sequentially, consumer loans increased 6%; credit cards, however, remained weak despite continued penetration of the open market. As usual, it is still affected by the fiscal reform. Nonetheless, we doubled system growth rates in this product. This was achieved even though the more than 160,000 new cards placed during the quarter have not yet contributed to loans. Note that they continue to maintain our prudent credit scoring standards as we tap the open market.

Commercial loans rose 18% year-on-year with important contribution from all segments. We maintained our leadership position in the high potential SME market, expanding this portfolio up 24% year-on-year, significantly above market. We remain focused on further developing this profitable market while maintaining our prudent approach to risk.

In the middle-market loans, we also posted strong growth, up 15% year-on-year, doubling the market. And the corporate loans expanded 16% year-on-year. As anticipated, this quarter, we syndicated a large loan that was granted in the fourth quarter of last year, but compensated that effect with new loans origination.

Finally, loans to government and financial entities rose 20% year-on-year, principally reflecting lending to the two state-owned energy companies in the country. This was achieved despite partial payment by Pemex following a strong loan demand last quarter.

In terms of funding, our strategy centers on high-income clients, our ongoing focus on SMEs, and the branch expansion program continues to support deposit growth. While sequentially, deposits were seasonally flat, demand deposits were up 15% year-on-year, optimizing cost of funding, with term deposits up 14%. Let me highlight the good behavior on individual demand deposits, up 23% year-on-year, doubling the market too, as well as SMEs and middle-market and demand deposits, which expanded about 20% during the period.

We maintained robust liquidity with a loan to deposit ratio of 100%, which together with our strong capitalization of 16.6%, provides room to further expand our loan book as demand increases. Additionally, our healthy debt maturity profile positions us well for the anticipated increase in interest rates this year. Finally, this quarter, we have also begun to report liquidity ratios as per Banxico regulation, which are comfortably above the required limits.

Now looking to the NPL, net interest income was up 1.3% quarter-on-quarter and 10.4% year-on-year. This reflects increases of 13.1% in net interest income from the loan portfolio, including credit cards, and a 14.6% increase in net interest income coming from investments in securities, which more than offset the weaker performance in credit cards. The expected recovery in consumer activity and the acquisition of the Scotiabank portfolio effective this month should contribute to drive net interest income growth. Net interest margin for the quarter remained stable at 4.87% on a sequential basis, despite a good performance in the net interest income due to the proportional increase in productive assets.

Moving onto commissions, the weakness in credit cards, financial advisory and capital market fees that were mainly driven by external factors, more than offset the good performance in insurances, cash management, and investment fund fees. As you may know, since early last year, we have been seeing lower credit card usage market-wide, reflecting concerns of higher tax supervision as a result from the fiscal reform. At the same time, we continue to incur new placement costs through telemarketers to tap the open markets, which has allowed us to grow this portfolio above the market levels. To give you some color, credit cards were the largest contributor to fees, representing a fair part of the field before the fiscal reform was enacted. Today, however, credit cards rank third in terms of fee contribution of insurances and cash management.

Financial advisory fees were particularly weak this quarter, reflecting the lower execution of large energy and infrastructure projects. Furthermore, year-on-year and quarter-on-quarter, operations reflect that the first and fourth quarters of 2014 were our strongest quarter in terms of the investment banking operations. Remember that this line is volatile as it depends on the project execution and the market conditions. Nonetheless, we maintain a strong pipeline which is expected to materialize as the business environment improves and the market conditions recover.

Gross operation income was up to 8% year-on-year, reflecting a strong performance in net interest income, with trading gains back in line with our estimated quarterly average of around 700 to 800 million. More significantly, despite the weakness in fee generation, gross operating income rose 3% sequentially, reaching a record high, surpassing the 4 billion peso mark. Let me also highlight that 94% of our gross operating income was composed by core earnings

In terms of asset quality, loan loss reserves returned to average levels after reaching an unusual low in the fourth quarter of last year, resulting from recoveries in the period. Most importantly, loan loss reserves rose 6% year-on-year, significantly below the 16% increase in the loan portfolio. Cost of risk declined quarter-on-quarter, down 19 basis points and fell 32 basis points year-on-year, increasing the coverage ratio to close to 100%. We also achieved a sequential improvement in asset quality across practically all business segments, resulting in NPLs declining to 3.68% in the quarter. Let me highlight the declines of 57 basis points to consumer NPLs and 24 basis points in SMEs. Despite the low volume in credit cards, NPLs for the product improved 33 basis points quarter-on-quarter.

Moving down the NPL, while expenses increased 8% year-on-year, this includes a 23% increase in the deposit insurance fee, or IPAB, which represents 40 basis points of our funding. Remember that under international accounting standards, this line item will not be included within expenses. Excluding the insurance deposit fee, operating expenses would have increased by 7.1% year-on-year, in the mid-range of our guidance for expenses, which also excludes this fee.

Personnel expenses rose 13%, reflecting the 15% increase in the average workforce during the period to support business growth and the expansion plan. Administrative expenses were flat as our efficient cost management is offsetting both incremental costs of the new branches as well as personnel expenses. Note that 66 branches, which represents one third of the branch expansion plan, were opened in the last quarter of 2014 and most of the associated costs started to materialize this quarter. This represents 1.6 percentage points of the increase in expenses. Excluding the impact from the new branches, depreciation and IPAB, expenses would have increased slightly above inflation.

So, while the efficiency ratio rose 0.5 percentage points year-on-year to 44.8%, remember that this was impacted by the factors I just explained, as well as weaker than anticipated activity in both credit cards and fee-related business. Going forward, costs are expected to remain relatively flat sequentially as we maintain our efficient expense management. These, together with a strong gross operating income driven by core earnings, are anticipated to allow progressive improvements in efficiency in the following quarters.

The full impact of the 550 basis point increase in the effective tax rate up to 23.5% from 18% a year ago resulted in 1.4% year-on-year decline in net income and a 12% ROE for the quarter. Pre-tax profit rose 5.8% during the period, and we anticipate it will increase progressively throughout the year, driven by the following factors. The first one, the financial margin is expected to maintain an upward trend as we continue to build our loan and securities portfolio. Second, fees are also anticipated to show a better performance as the project pipeline materializes. Third, provisions are anticipated to remain in line with our guidance as we maintain origination standards. Finally, costs are expected to remain relatively stable in the following quarters as we keep our efficient expense management. We believe a combination of these factors can only lead to a sequential recovery in net income and in ROE during the year.

To finish, finally, moving onto guidance, we maintain our outlook for the year provided on our previous earnings call. This is based on the strong performance achieved across most business segments, once again beating market rates and a cautious but optimistic view of the recovery of the Mexican economy, particularly following the recent pick-up in consumer activity. This means that we expect loan growth to range between 13 and 15% in the year with consumer loans expanding between 12 and 15%, mortgages 10 to 12%, and SMEs by 22 to 25%. We anticipate deposits to grow between 10 to 12% during the year as we continue to ramp up our new branches and the economy recovers. At the same time, cost of risk is expected to range between 3.4 and 3.6% in 2015.

We also believe operating expenses will increase between 6 and 8% as we continue to maintain tight cost controls while investing in our strategic business. Remember, this growth doesn’t include the deposit insurance fee and the reversal of the employee profit sharing programs that refers to the real cost of operations. This should result in pre-tax earnings increasing by 15 to 20% with an effective tax rate between 23 and 25% for the year as we compare just through normalization.

With this, we finalize the presentation, and we are ready to take your questions. Please go ahead.

Operator:

Thank you, and as a reminder again, if you'd like to ask a question, that is star, one. Again, if you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, that is star, one for questions.

We'll take our first question from Diego Batista with Itaú.

Diego Batista, ITAU:

Hi guys. Thanks for the opportunity. I have basically two questions. The first one is on margins, and the second one on the cost of risk. On margins, we saw that your loan margins were flat Q-over-Q but contracted a bit year-over-year despite the fact that your portfolio expanded faster on consumer and SME the last 12 months. So my question is could you comment on your view on the loan margins going forward? How do you believe margins will perform during the year?

My second question about the cost of risk, your guidance for cost of risk for the year is 3.4 to 3.6, but in the first Q, your cost of risk was only 3.21, so my question is do you see your provision expenses increasing during the year, or maybe your cost of risk will be below the guidance?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Well in the first one, at this moment it's stable, the NII, but we are expecting that it will be becoming a better one during the year; it will be passing because of the mix of the portfolio. In the cost of risk, this quarter was a better one. We don't see that it will be a deterioration in the portfolio, it's just that we are maintaining our guidelines just to be conservative. But no surprises are we expecting to have.

Diego Batista, ITAU:

Okay.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Then maybe at the end of the year, what you will see is as the homebuilders, because of the way that we have to administrate the NPLs, they will be affected at the end of the year because they will have passed the 18 months after not paying and then you will have an impact there, but it's only an accounting issue. On the other side, if you see the Pemex suppliers that have been affected, the contractors of Pemex are not included in this quarter, and the Scotiabank—at the end, the Scotiabank portfolio that we have acquired will affect because we are carrying in a price that includes the quality of portfolio, but it has to be reflected in the cost of risk in the NPLs by around 400 million pesos.

Diego Batista, ITAU:

Okay, thanks for the answers.

Operator:

We'll take our next question from Philip Finch with UBS.

Philip Finch, UBS:

Good morning, Marcos. Thank you for the presentation. I've got a couple of questions as well. My first question is regarding your loan growth, which has shown really good across the board growth in recent quarters. The one exception is credit cards, which have been really sluggish. Now, this seems to be an industry trend as well, but from your expectation going forward, what sort of improvements can we expect in this segment, if any at all? Secondly, my second question, you've maintained your guidance for pre-tax earnings growth of 15 to 20% for this year. In the first quarter, it was only 5.8% growth year-on-year, so going forward, what are going to be the key drivers to get to your guidance? Thank you, Marcos.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Well in the first one, talking about credit cards, we think that this tendency will take a while to change because the government insists in fiscalizing people by the use of the credit cards, even though now they are aware that this has been the result of this strategy and they are starting to be worried. To do something different will take them some time, but fortunately, people are not using the credit cards but are using personal loans and payroll loans. That's why if you see, we are growing 20% that portfolio, that is not only twice the market is doing it but is very different than the 8% that we were growing some quarters ago. The combination of both of the portfolios is why we are expecting to grow between 10 and 12%. That is not a bad growth for this very profitable segment. We are expecting that government is going to do something about the credit cards in the second half of the year, and it will help us more in 2016 than in 2015.

Talking about the pre-tax earnings, I will ask Pedro to give you an explanation about that.

Pedro Moreno, Deputy President of Administration and Finance:

Yes, right now we are growing only 6% year-on-year, and we expect to accelerate this rhythm to the range between 15 to 20% at year-end. The drivers for getting that is mainly the income line. We are now —already we go to double-digit growth. We are in 10% growth year-on-year and accelerating to 15% at year-end. This will be the natural development of the net interest income of the portfolio we are building up, and at the same time, we expect some recuperation in the fee income line. This is the one that is affecting mainly these first quarter results. If you ask to this acceleration in the income that the expenses will be controlled, this quarter, we have jumped up to 8% because we recognized from the very beginning the impact of the branches opened last year, as well as the inflation accrual for all the expenses. These should be relatively flat quarter-on-quarter in the future, and with the expectations we have to maintain the loan loss reserves growing below the rhythm of our loan book, this will lead you mathematically to this acceleration and to achieve our target, so we maintain that as very feasible.

Philip Finch, UBS:

Right. Thank you, Pedro. Thank you, Marcos.

Operator:

We'll take our next question from Marcelo Telles with Credit Suisse.

Marcelo Telles, Credit Suisse:

Hi, good morning gentlemen. Thanks for your time.

Hector Chavez, Managing Director, Head of Investor Relations:

Can you speak louder, please, because we cannot hear you, Marcelo.

Marcelo Telles, Credit Suisse:

Sure. Can you hear me better?

Hector Chavez, Managing Director, Head of Investor Relations:

Yes. Much better.

Marcelo Telles, Credit Suisse:

Okay, thank you. I have two questions. The first one is regarding your guidance for earnings growth, more pre-tax earnings growth, that you're expecting 15 to 20% earnings growth for the year. But if we look at the growth rate from the first quarter this year versus first quarter last year, we see you are well below that. So how confident are you that you're going to be able to deliver this 15 to 20% growth in pre-tax earnings so it's going to be the main driver of improvement so that it can match that guidance going forward?

The other question is regarding your SME portfolio. Clearly you've been executing very well the growth in that portfolio. My question is how comfortable are you that you're not going to face delinquency, incremental delinquency in that portfolio going forward, because you've been growing very strongly and we've seen that happen in some other segments over the past years. So what makes you comfortable that it is not going to happen this time? Thank you.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

You're welcome. Starting with the SMEs portfolio, we feel very comfortable in the way that it has been behaving, this portfolio for the last five years. What we are doing at this moment is to grow more in the medium than in the small ones, and our expectation is that they will behave even better than the portfolio has been doing in the past because they are more formalized companies and because we are expecting a better macroeconomic scenario in the future than is what happened in the past.

Saying that, we still have some kind of guarantee in 60% of the portfolio, and we are not using it because the behavior has been a very stable one, then we feel very comfortable about that. The third one, as Pedro has told just in the last question, we are expecting to grow the pre-tax earnings because the financial margin is going to improve during the year and to 15%, and the fees that have been very weak this quarter, not only because of the credit card operation but because the investment banking pipeline has not been executed, but it will be doing during the year, and the cost will be stable. That's the reason why increasing the income and maintaining the cost control will allow us to have a pre-tax profit between 15 and 20%.

Marcelo Telles, Credit Suisse:

Perfect. Thank you very much.

Operator:

We'll take our next question from Saul Martinez with JP Morgan.

Saul Martinez, JP Morgan:

Hi, good morning, guys. I'm also struggling with the 15 to 20% pre-tax earnings growth, but I guess you guys have addressed it on a couple questions, so I'm just going to ask one more detailed question on the Scotiabank acquisition. I think it's a 3.2 billion peso portfolio. Can you just give us a sense for what the incremental lift-off is to your NII, remind us again, and forgive me if you already did discuss this, but what kind of provision you're going to take against that and essentially what kind of pre-tax earnings benefit, how accretive is this acquisition to your bottom line?

Pedro Moreno, Deputy President of Administration and Finance:

Well the Scotiabank operation, this first year in 2015, we are estimating a zero impact in our net income. This is due to the methodology for reserves that we have to create, anticipated the expected loss. So provisions will be greater in one shot this month of April. These will be offset by the net interest income generated minus the expenses related to the operations, so profit will be zero this year, and then gradually, as the portfolio will be maturing, we will release provisions and the interest income will remain, so this will happen in the year 2016 and 2017. The turnover of this portfolio, the duration is, like, 1.8 years, so it will be over in 2017.

But just as a summary, the impact this year is zero and positive in the coming two years.

Saul Martinez, JP Morgan:

But the negative impact is in one shot though, in April, and then you get the incremental benefit on an ongoing basis?

Pedro Moreno, Deputy President of Administration and Finance:

That's right.

Saul Martinez, JP Morgan:

Can you share what the average yield is on your portfolio? Is it similar to the (inaudible)?

Pedro Moreno, Deputy President of Administration and Finance:

Yes, very similar. The yield of this portfolio is like the standard consumer loan growth, around 20% spread.

Saul Martinez, JP Morgan:

Twenty percent spread?

Pedro Moreno, Deputy President of Administration and Finance:

Yes.

Saul Martinez, JP Morgan:

That's helpful. Thank you very much.

Pedro Moreno, Deputy President of Administration and Finance:

You're welcome.

Operator:

We'll take our next question from Martin Lara with Actinver Securities.

Martin Lara, Actinver Securities:

Good morning, Marcos and Pedro. Thank you for the call. I only have one question. In the government segment, do you think that the strong loan growth is sustainable going forward?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Well, what we are—it's sustainable, maybe not the percentage of growth; I said 20%. Where we see is that we are very well positioned in the new projects, the infrastructure ones that are going to happen, the pipeline that we say is waiting to be executed. What we are seeing is that even though they are like bridge loans to have the possibility to syndicate after that or in the near future to be replaced by market operations, we will maintain these bridge loans and this participation in the origination in most of the projects. That's why we are confident that it will be a very busy business, the government loans related to activity and Pemex substantially, and sometimes to the airport, that kind of project that will lead us to maintain a higher amount in these loans. But it won't be permanent loans, it will be transitory loans.

Martin Lara, Actinver Securities:

Okay, and what is the growth that you anticipate here for the rest of the year?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

I cannot give you a sure—what amount, because it all depends at the time that the projects can be executed. But we are expecting that starting this quarter, activity will be—to be in place.

Martin Lara, Actinver Securities:

Okay, thank you very much, Marcos.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

You're welcome.

Operator:

We'll take our next question from Victor Galliano with Barclays.

Victor Galliano, Barclays:

Hi, thank you for the opportunity. Just two questions from me, one follow-up, I'm afraid to say, on the financial margin forecast here. I just want to make this clear, and I apologize if you did mention this earlier, but are you assuming that benchmark rates are higher in the second half of the year than they are in the first half of the year, and is that part of the higher margin story? That's my first question.

My second question is about costs, and really what I want to understand is kind of the quarterly impact of the rollout of your branch network. Is this pretty much done now, so are we going to see very little incremental cost impact from the rollout of the branch network? Thank you.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

You're welcome. In the second one, because we have already almost finished, practically finished our branch expansion, what we are expecting from now on is normalizing the costs and that you will see in the future is a behavior as much or slightly higher than the inflation. Then you are not going to see the rate that you have seen in the past. As Pedro told you, the impact was in the first quarter and we see this amount will be stable during the year, and that's why we feel that there won't be any surprise and that's why the growth of the income will be higher compared with the behavior of the costs. Yes, we are expecting an increase in the interest rate of around 50 basis points in the second half of the year that affect to the margin in a thousand million pesos annually speaking.

Victor Galliano, Barclays:

Okay, so you would expect an impact of about 500 million in the second half from benchmark rates?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Right. Around that.

Victor Galliano, Barclays:

Yes. Thank you.

Operator:

We'll take our next question from Chelsea Konsko with TIAA-CREF.

Chelsea Konsko, TIAA-CREF:

Hi, and thank you for the call. I just have two questions. One is related to your loan-deposit ratio. It's slowly been increasing pretty much each quarter, and based on your guidance for this year, it seems that it will also increase further. So I'm wondering, where are you comfortable in terms of loan to deposit ratio, how high will you let it get?

My second question is related to the mortgage segment. On a year-over-year basis, it seems that the NPLs increased rather significantly, so I'm wondering if you could elaborate a little bit on that and also tell us what is your loan to value in the mortgage segment?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

This is related to the ING acquisition of the portfolio, and I will ask Pedro to give you more detail about that.

Pedro Moreno, Deputy President of Administration and Finance:

Yes. Well, as you remember, when we acquired the ING portfolio, we did it at $0.49, so it means that we already calculated that this impact will occur. We knew the quality of the portfolio. I can assure you this has been a very, very profitable acquisition for the Bank, and this was already discounted in our predictions for non-performing loans. Excluding that, the behavior of the own generated originated mortgage portfolio at the Bank is one of the best qualities in the system. We are focused on high-end customers, so we are not going into low-end portfolios which are more risky. I can tell you the cost of risk of mortgages is below 1%, so we are very satisfied with the quality. We are not observing deterioration of the new vintages, so we are very happy with the standards of our origination and we will keep it. The non-performing loan ratio will improve as the ING portfolio will mature, so we are not worried about that.

The rest of the segments are also behaving very, very well. We are very happy with the new vintages of all businesses—consumer loans, credit cards, SMEs, so really very, very confident on that.

Chelsea Konsko, TIAA-CREF:

What is the average loan to value, including ING, for mortgages?

Pedro Moreno, Deputy President of Administration and Finance:

At the origination level, it's 85. In the portfolio, it's like 65% loan to value.

Chelsea Konsko, TIAA-CREF:

Thank you.

Operator:

We'll take our next question from Arturo Langa with Itaú BBA.

Arturo Langa, ITAU BBA:

Hi, good morning. I think my questions were answered, so that's it for me. Thanks.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

We cannot hear you.

Arturo Langa, ITAU BBA:

Yes, my questions were answered. Thank you. No questions from my end.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Okay.

Operator:

We'll take our next question from Carlos Gomez-Lopez with HSBC.

Carlos Gomez-Lopez, HSBC:

Yes, hello. Thank you for taking my questions. Two of them. On the tax front, you have given us guidance for 23 to 25% for this year. Could you also remind us what your guidance would be for the coming years, 2016 to 2017, and have you found any further opportunities to optimize your tax rate as you did last year?

The second question would be regarding the Scotiabank portfolio. It's 39,000 loans. Do the loans also include the relationship? Do you bring accounts? Are they now clients of Santander, and what would be your assumption for retention of this portfolio? Thank you.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Well starting with the second one, these 39,000 loans is not only an opportunity to increase our margin and the income of the Bank. What is really the attractiveness of this portfolio is the possibility to bring them to the Bank and to make them clients of the Bank, not only a portfolio but new clients for the Bank. We have enough time, more than four months, preparing the teams of the Bank and doing the strategy to bring them and to share at least these clients with Scotiabank in the future, but preferably to bring them and to make them new clients for the Bank. It is starting, doing pre-approved offers for an important number of them to give them a restitution and credit increase in the actual balance, because most of this portfolio is in the middle of the time of the duration, then we have the possibility to offer them again the amount that was the original one in a completely new loan, originated inside of the institution, and that gives us the possibility to start working to them.
Saying that, and the taxes, Pedro, can you—?

Pedro Moreno, Deputy President of Administration and Finance:

Yes, sure Carlos. Yes, we maintained the guidance for this year. Taxes will be around 24%, 25%. Let me remind you that the regulatory tax rate in Mexico is 30%. We expect for the next year being close to 26, and in the year 2017, 28. Going forward, we expect to maintain this. As you can see, we are always looking for tax strategies and tax management. This 28% guidance for the future includes already 200 basis points of tax improvements, but of course we will continue trying to find out something else. But this realistic to think that 28 can be a standard, a normalized tax level for this Bank.

Operator:

We'll take our next question from Chelsea Konsko with TIAA-CREF.

Chelsea Konsko, TIA-CREF:

Hi, just following up on my other question, which I don't believe you answered, on the loan to deposit ratio. It seems it's been rising and you expect it to continue to increase, considering your guidance for deposit growth this year. So I'm just wondering how high you expect that ratio to get, and what's a comfortable level for you?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Yes, you are right. We are close to 100% loan to deposit ratio, which is very healthy. We are growing a bit more the loan book than the deposit base, but nevertheless we feel very comfortable at levels around 110, 115, very easily managed because don't forget that the Mexican financial system is very liquid. There is a lot of demand for issuances of institutions like ours. We are not using this tool, but it would be very, very easy to get liquidity at very, very attractive prices. Probably you have noticed that we—it's the first time we have published the liquidity ratios that will be in force from now on for Basel III regulation, and as you can see, we are 116% so very comfortably above the minimum regulatory standards, which in Mexico is nowadays 60%. So we manage liquidity without difficulties, and we foresee the next years to be comfortably above 100% in this ratio and funding ourselves with many, many instruments in the market without increasing the cost of funding.

Chelsea Konsko, TIA-CREF:

Okay, thank you.

Operator:

As a reminder again, if you'd like to ask a question, that is star, one. Again, that is star, one if you'd like to ask a question.

As a reminder again, if you'd like to ask a question, please press star, one.

We'll take our next question from Carlos Gomez-Lopez with HSBC.

Carlos Gomez-Lopez, HSBC:

Yes, one final question; a follow-up on asset quality. As it was mentioned before, your first quarter has been better than what you guide for. How long would you have to wait until you decide to modify your guidance for the year?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Sorry, Carlos?

Carlos Gomez-Lopez, HSBC:

How long would you have—would you have to have one, two, three good quarters before you decide that you could modify your guidance for cost of credit for the year?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Well, even though we are maintaining the guidance, as we told you before, we are just expecting some methodology impacts in the portfolios, especially in the homebuilders, that at the end of the year we have to register the last part of the portfolio that is not affecting at this moment the cost of risk. In the Pemex contractors, we are cautious about how they are going to behave in the restructure of the different contracts for them. Actually, Pemex is negotiating with the most important contractors or suppliers, and because they are changing the conditions to them not only in terms of the income but in terms of the time that the contracts includes. We think that it will be necessary for some of them to restructure the loans, and as you know, when you restructure a loan, by the regulation, the Mexican regulation asks you to put in an NPL in the loan until it happens some payments that assure you that you have a—that the company has the possibility to repay the loan. Because we don't know how much of these contractors are going to be restructured, we prefer to leave this guidance and to wait one quarter or two more quarters until they finish the negotiation between Pemex and the contractors.

Carlos Gomez-Lopez, HSBC:

I understand. Thank you very much.

Operator:

We'll take our next question from Martin Lara with Actinver Securities.

Martin Lara, Actinver:

Marcos, what is your exposure to the oil sector, including Pemex?

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Our exposure to Pemex?

Martin Lara, Actinver:

Yes, the oil sector, including Pemex and contractors.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

Oil and gas is 6% of the total portfolio, and to Pemex directly is half of it, 3%. That is—and 1.5% to the contractors.

Martin Lara, Actinver:

Okay, thank you very much.

Marcos Martinez Gavica, Executive President and Chief Executive Officer:

You're welcome.

Operator:

This concludes the question and answer session. I would now like to turn the conference back over to our host, Hector Chavez, for any additional or closing remarks.

Hector Chavez Managing Director, Head of Investor Relations:

Thank you, Operator. Well, thank you very much to all of our participants for joining Santander Mexico on this call. We look forward to maintaining an open dialog with you, and you are very welcome to visit us in Mexico. If you have further questions, please don't hesitate to call us or email us, and have a good day. Thank you very much again.

Operator:

This concludes today's conference. Thank you for your participation. You may now disconnect.