Banorte

Q2 2020 Earnings Conference Call

Friday, July 24, 2020, 10:00 A.M. Eastern

CORPORATE PARTICIPANTS

Tomas Lozano – *Head of Investor Relations, Financial Intelligence and M&A*

Jose Marcos Ramirez Miguel – *Chief Executive Officer*

Rafael Victorio Arana de la Garza – *Chief Operating Officer and Chief Financial Officer*

René Gerardo Pimentel Ibarrola – *Head of Corporate*

Gerardo C. Salazar Viezca – *Chief Credit and Risk Officer*

PRESENTATION

Operator
Good morning. Welcome to Banorte Second Quarter 2020 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing star (*) key, followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*), then one (1) on your telephone keypad. To withdraw your question, please press star (*) then two (2). Please note, this event is being recorded.

I would now like to turn the conference over to Tomás Lozano, Head of Investor Relations. Please go ahead.

Tomas Lozano
Thank you. Good morning. I'm Tomas Lozano, Head of Investor Relations, Financial Intelligence and M&A. I hope everyone is doing well and safely adjusting to the new reality in your hometowns. Welcome to Grupo Financiero Banorte Second Quarter Earnings Conference Call.

Today's presentation may include forward-looking statements that are subject to risks and uncertainties, which may cause actual results to differ materially. We ask you to take this into consideration.

Our CEO, Marcos Ramirez, will provide an update on the implications of the first full quarter into the lockdown in Mexico and the evolution of different measures aimed to strengthen the group. Furthermore, Marcos will comment on relevant events that took place during the quarter and will walk us through the main financial performance results.

Meanwhile, Rafael Arana, our COO, will provide further detail on financial and operating results and will share some additional color on our expectations for the second half of 2020. As always, we will conclude with a Q&A session.

Thank you. Marcos, please go ahead.

Jose Marcos Ramirez Miguel
Thank you, Tomas. Good morning, everyone. Thank you for joining our call. I'm glad to talk to you again, wishing that you and your families are safe and in good health.

From beginning to end, the second quarter of the year reflected the full effect of the pandemic on a global scale. We have witnessed an unprecedented and challenging environment in which to live, in which to interact, in which to do business. Throughout this period, more than ever, we have been true to our commitment of being the strong bank of Mexico. Our efforts at Banorte have been focused on supporting our customers, taking care of our employees, and ensuring a continuous and solid operation of our franchise amidst generalized uncertainty.

For Mexico, the past three months have meant a significant decline in economic activity across many sectors, as most nonessential activities such as tourism, entertainment, construction, retail activity, and many other services came to a halt. Therefore, impacting large and small companies and individuals alike. Since the start of the outbreak, both the federal government and Banxico undertook actions to support households, businesses, and the economy as a whole. Main actions include increased spending in health care and the advances on social benefits to the most vulnerable groups, such as the elderly. Programs with an economic focus have mainly consisted of unsecured loans to both lower income individuals and SMEs, supported by guarantees from development banks.

There have been also efforts from the Central Bank to improve liquidity in financial markets and ensures a stability in the exchange rate market. The most recent meeting from the Central Bank resulted in a unanimous 50 basis points cut to the reference rate, which now stands at 5%, totaling a 225 decline versus January 2020. Market consensus points towards further reductions during the second half of the year to reach 4% by year-end. Actions from the CNBV includes some loosening of regulations from banks, contributing to increased lending.

The private sector has taken a much more active role in Mexico, with the Mexican Business Council partnering with IDB Invest to provide up to $12 billion in loans to SMEs.

All in all, there has been a broad response to the health and economic crisis, but there is still room for further stimulus. So far, the different measures, excluding those from Banxico to bolster liquidity, totaled MXN 994.2 billion, or 4.5% of GDP. Despite these actions, the depth and breadth of the lockdown period has further reduced growth expectations in Mexico, which now points towards a 9.8% GDP contraction in 2020. Later, Gabriel Casillas will provide further detail on these matters.

Starting on June 1st, the Federal Government announced a gradual reactivation of the economy, prioritizing those industries with the highest economic impact of the country such as exporter-related manufacturing, construction, and tourism, followed by a slower reactivation of retail activity. The full effect of this reactivation is expected to influence our results in the months ahead. Thus, it is not yet reflected in these quarterly results.

Focusing now on Banorte. During the quarter, the bank remained fully operational, with 85% of our branches and nearly 100% of our ATMs networks available for our customers. Our branches operate with at least possible staff and follow strict health guidelines to keep our employees and customers safe. Over 70% of our employees at the corporate offices remain working from home, and we're evaluating different strategies and prudent timing to implement a safe return to our offices.

As you know, from a risk standpoint, we took measures early on to contain asset quality in our loan portfolio by tightening our risk policy, concentrating our loan growth efforts to serve our existing customer base, and working very closely with the asset recovery arm.

Beginning with the Slide 3. In the last week of March, we were the first bank to launch a relief program for our consumer and SME customers. The enrollment window was open from March 24 through April 30. Very welcomed by our clients, as 22% of our consumer portfolio and 35% of our SME book joined the program. 16% of our total loan portfolio is supported by this relief. We are ready to implement a second phase of support programs, leveraging on our data analytics capabilities to access individual risk levels in order to grant an additional 1- or 2-month grace period. This second phase will be open for previously enrolled as well as for new applicants.

We also proactively approached our key commercial and corporate customers in vulnerable industries and supported them with additional short-term liquidity lines on a case-by-case basis to help them overcome their most immediate cash flow requirements.

Now that we have more clarity on the enrollment rate of our relief programs, we decided to provide more visibility to the market in our expectations for asset quality. Thus, we requested authorization from regulatory authorities to generate MXN 4.9 billion in additional loan loss provisions. Out of this amount, MXN 1.9 billion were specifically assigned to write-off existing SME and commercial portfolios, and MXN 3 billion were anticipated as additional general provisions that we estimate will be enough to withstand the expected asset deterioration in 2020 and the anticipated peak in the year 2021.

Switching gears to the Slide 4. One of the positive outcomes of this pandemic has been the unprecedented hike in adoption and utilization rates of the bank's digital channels. Transactions are migrating to web and mobile channels, where we see significant transaction growth versus pre-COVID levels.

Leveraging on this significant increase, we kept enhancing our digital product suite by adding payroll loans to the existing digital offering of basic checking accounts, credit cards, mutual funds, and insurance products. The convenience of our new digital products, together with the relief programs and the preventive measures that we have implemented have had a very positive impact in our customers' perceptions and experience with the bank. Our branch NPS score rose 9 points during the quarter, reaching 67 points and our mobile NPS rate reached 68 points, further consolidating our digital presence in the industry.

Another decisive step in our digital strategy was our recent JV between Banorte and Rappi, the leading on-demand delivery platform in Mexico. On Slide 5, you will see that this new venture is equally owned by Banorte and Rappi and will complement our digital offering by enabling us to offer convenient financial products and services to nearly 11 million native digital, young, active clients, who interact in Rappi's fast-growing ecosystem.

Now turning to the Slide 6, I will walk you through the main financial performance metrics for the second quarter. Operating results were positive overall, with good performance in the bank and the rest of the group subsidiaries. When we incorporate the additional loan loss provisions at the bank, Grupo Financiero Banorte net income for the quarter totaled MXN 6.52 billion, and without this impact, net income would have been MXN 9.87 billion, up 8% versus the previous quarter. Consequently, our profitability metrics were also impacted, in particular, our return on equity, as it carries the effect of additional provisions and also the effect of accumulated capital at the group's level from the dividends that have not been distributed. Return on equity for the quarter totaled 13%, while return on assets reached 1.49%.

Quarterly net income--net interest income, the NII, on the Slide #7, was up 6% compared to last year. However, it shows an expected reduction versus the first quarter of the '20, primarily explained by the high seasonality in the insurance business during the first quarter of the year, and to a lower extent, by the decline in reference rates during the quarter. Our initiatives to reduce our cost of funds have sustained it at 47% of the reference rate, adding resilience to our NIM, which ended the quarter at 5.3%. Core deposits continue with a positive evolution, with a 4% increase during the quarter, 6% growth in demand deposits, while time deposits declined 1%.

Moving on to Slide # 8, this has an interesting evolution, while those linked to loan originations were impacted by lower economic activity, transactional ones such as credit card fees, were more resilient as declines in certain sectors were offset by relevant increases on online retailers. As of June, those fees were back to pre-COVID levels.

On Slide #9, loan growth was primarily driven by mortgages, which had a 2% quarterly growth despite the intense market competition during the period. Our corporate and commercial portfolios also showed good performance, supported by liquidity lines that were granted for key customers and by the absence of prepayments, which prevented loan growth dilution. In line with our expectations, relief programs have had a positive effect on asset quality as this reduced the pace of NPL formation across the portfolio. Excluding the effect of the MXN 1.9 billion write-off mentioned earlier, NPL ratio for the quarter will have remained at 1.7% instead of declining to 1.2%. The cost of risk was also impacted by the additional provisions, reaching 4.2% during the quarter. Excluding this effect, it will have dropped to 1.8%.

On Slide #10, our liquidity position was further strengthened by the quarterly increase in deposits, reaching 151%, way above regulatory requirements. As for our capital position, on Slide 11, total capital rose to 19.7%, while CET1 totaled 13.2%, leaving the bank in a solid position to face the second half of the year.

Talking about our nonbanking subsidiaries on Slide 12, the insurance business showed good results, considering their normalization from a seasonal increase in premium income in the previous quarter. Moreover, the annuities business now incorporates the recent acquisition of Sura's annuities portfolio. We expect very good performance in this business going forward as we materialize cross-selling initiatives to this new customer base.

The second half of the year will uncover the effects of the pandemic for the rest of our customer base. However, I am confident that we have implemented the necessary measures and have taken a prudent approach to strengthen our franchise.

With this, I conclude my comments. Now Rafa will provide more in-depth information on relevant operation and financial metrics as well as additional details on the rationale behind our provisions and the impact of Grupo Financiero Banorte's profitability.

Rafa, please go ahead.

Rafael Victorio Arana de la Garza
Thank you, Marcos, and thank you, everyone, for attending the call. We have been talking to many of you during the past weeks concerning basically what's going to happen with the provisioning, what's going to happen with the NIM, what's the resilience of the bank and I think, as Marcos mentioned at the beginning of the call, if we go to the Slide 13, I think we could start by tackling the net interest margin. That has been of concern from many of you.

As you can see on the Slide 13, the net interest margin of the bank for the first half of '19 was 6.2% and for the first half of '20 is 6.0%, so 20 basis points less with a considerable reduction in the reference rate of 139 basis points. So, the resilience of the net interest margin of the bank has proven to be based upon a much more profitable mix on the consumer book, also a much better cost of funding as we anticipate, since the integration of Interacciones that when we raise the cost of funds to 54% of our reference rate, now we are sitting at 47%. And we will continue to lower that number to 44%. That is giving us the resilience on the NIM.

As you can see at the group level, the net interest margin stays the same for the first half of '19, that for the first half of '20, once you take away the first quarter increase in the margin from the insurance company. So, all in all, the margin still behaves in a resilient way, based upon all the actions that we have been taking with this and we expect to continue to reduce the cost of fund.

As you know, during the pandemic, and it has not only been the case in Mexico but also all over the world, since you get onto the relief programs, there's more liquidity in the market, and that liquidity has been--has allowed us to move the demand deposits on a 20% increase from a year-to-year basis. So, that is one of the main reasons why the cost of funds continued to drop.

So, we have more liquidity coming from our clients, not just the consumer but also the corporate one. So as you see, we will continue to see a resilient behavior of net interest margin. If you look at it from the loan portfolio based upon all the things that you know on the spreads, based upon the restrictions on liquidity and a much better mix on the portfolio, the NIM of the loan portfolio has moved 42 basis points up from the first half of '19 to the first half of '20. So overall, a very, I would say, accelerated drop in interest rates, but I think we have been able to cope in a very good way with--based upon the funding cost, the mix, the fixed rate portfolio that now it's close to MXN 300 billion, and that is giving us the necessary tools to try to contain the margin at a very reasonable levels.

Okay. There have also been concerns about what's going to be the effect on the reduction on the rates. On the sensitivity that, as you know, three years ago, the bank was running with a sensitivity that every 100 basis points was MXN 1.2 billion on the--of sensitivity due to the, I would say, very efficient work of all the teams related, the treasury, risk, finance, all the people, the commercial areas, we have been reducing that sensitivity to--in less of 100 basis points on sensitivity of MXN 1.2 billion to MXN 430 million. So, that has been a very, very good, also very good news in an environment that you see a drastic drop in interest rates, but you can counterbalance that with a very efficient managing in the ALCO book, okay?

Another thing that is important, and I think has to do with many of the questions that we have been talking to you in the past week is what's--why was the rationale for the provision and the number of the provisions that we set for the--for June? We have been doing a lot of work with the risk people, the recovery units, the product people to know exactly what's going to be the behavior as we could anticipate with the information that we have from the portfolios that have basically, on the consumer and also on the corporate and the commercial. As you know, we were the first ones to launch the relief programs on to the market and that really create a very important goodwill with our clients. When we launched the--this relief program, basically was aimed to stay at four months of no payments of interest and principal and then reset the loan after the fourth month, with no increase in the number of payments when you see the total loan history and also, the bank decided to finance the interest for the clients and the capital financing for these four months in order to avoid a confusion to the clients when you sit with them and they will look that there was additional months that they have to pay and they have moving parts on the balance sheet.

That is costing us, for the first year to MXN 240 million, and for the second year, it's going to rise to MXN 480 million, but this has also benefited us by this--having this relief program for a reduction of MXN 1.3 billion of reduction in past due loans. So, I will go into much more detail into this, but I would say that once we set up the relief programs, then we start looking at the behavior of our clients on a one-to-one basis to see on the payroll that we paid close to 6 million payroll accounts. What's really the flow that is coming to those accounts and link that to the payroll loans to see the evolution of those clients, how many of those were losing their jobs, how many of those were losing their salaries. So, we could--starting to build up a lot of information to see exactly what's going to be the behavior post this relief program.

The same happened on the credit cards, the same--we look at every single day what's the behavior of the credit card, what's the level of that with us and with the other banks, and a very good surprise for us is that people that sign for the relief programs continue to pay the credit card based upon that credit card became the main instrument for buying things on this remote way of doing things in the--during the pandemic.

When you look at the SMEs, that is also a portfolio that people are concerned with always. When you see these cash crunches and lack of dynamism on the economy, important to notice is that 3.8% of the total book is SMEs. SME was a book that didn't grow last year. We were flat or less than flat on the SME and more than 50% of the portfolio is on the Nafin guarantees. Notwithstanding that, we are taking an approach on a one-to-one basis with the SMEs by visiting them on a personal basis, look at the business, see the potential of the business to continue after the pandemic, so we have a pretty good idea of what's going to be the necessary buildup of provisions on the SME. And it's basically one of the main numbers that we use on this additional provisions that we just built up on to June, was devoted to the SMEs and also for the commercial on a specific way on the write-off part.

Before this buildup of provisions, the SME on the write-off was up to 19 months. Now we'll reduce that to 10 months in order not to have any boggles on the SME book and I'm going to run you some numbers about what's going--what was exactly the buildup of the provisions. And there have been some concerns that even without the provision and there was a rise in the past due loans, and that's not the case. Let me just run you from the numbers. If you look at the recurrent numbers without the buildup of provisions for the quarter, the number should have been MXN 3.5 billion of provisions. That is, if you compare that to the MXN 4.3 billion of the first quarter, you see a reduction of MXN 756 million on the past due loans on the book. When you add the provision in line, that jump to--instead of being MXN 4.3 billion on the first quarter, that jumped to MXN 8.4 billion on the second quarter--then it's when you include the full provision in the MXN 4.868 billion of provisions. Of this, MXN 3 billion were provisions against the income statement in June and MXN 1.8 billion was basically used for write-offs in order to clean the portfolio on the commercial and on the SME, that will allow the balance sheet to have enough room to support any deteriorations coming from the pandemic and after the relief program.

It's worth to notice that the regulators allow us to also move from the original four months program, in some cases, to add one or two months, depending on the clients. What we did is not on the--like in the first one on the general terms, we, in the second wave of this relief program, is on a one-to-one basis based upon the capacity of the client to become current, some clients that they continue to be employed, but they have been had a reduction in their salary, so they need some more time on relief. So, we are on a very one-to-one basis on this second wave that shouldn't move the expected numbers that we reserve from this provision is more than we anticipated.

These numbers that we build up, this MXN 4.8 billion should be enough for all of '20 and most of '21. I think we will consider that '21 will be covered enough, but we are not sure at this point, but we are in a way, confident that, that will be the case. And the reason for that is that during the relief programs, what really happens on the recovery units that allow the portfolios to, in a way, become much more clean, is that there's no migrations from bucket 0 to bucket 1 to bucket 2, because all those contention lines rise to record levels, so creating this MXN 1.3 billion of relief in the NPLs that we expect that will come from the coming months. So, all in all, we are confident with the numbers that we are reserving. There has been a very dedicated and extreme detailed analysis of these programs and evolutions and cost of risk. Some of you ask us when this is going to peak. Our expectation is that this will peak, and I'm also looking at other parts of the world that I think we are reaching the same numbers, that this will reach in the second quarter of 9--of '21, when our cost of risk will be close to 3.9% and then drop again to the usual numbers of the 2.1%.

It's quite important to notice that Banorte enters this cycle of pandemic with record numbers on NPLs, on cost of risk, on the low end of those numbers from and also with a very strong capital base on that. There have been some questions, what was the charge of this 3 point--MXN 4.8 billion against the capital base? It was 18 basis points against the capital base, what we consume of the--with this additional provision. So, instead of the 13.46%, we are now sitting in core Tier 1 of 13.21%. That is a substantial rise against the first--the numbers from the first quarter--on the first quarter.

If I move now to the other lines that we are doing to control the lack of evolution on the margin side that we have seen, we have control in that, but we know that we are losing some basis points on the margin side. We are dealing with the cost lines, not with the personnel expenses, because we are not laying off any of our colleagues in 2020. But basically, we are taking away most of the discretionary cost in order to reduce the guidance that we gave to you at the beginning of the year of 5% to 5.5% expansion on the cost line. Now we are looking at a number very close to 4% or below 4%. This continues to support a good cost-to-income ratio that should continue to move in the right direction.

If I can, as Marcos said, and I would like to stress, is that the bank, based upon the structure of the group in addition to the bank, it’s becoming more and more resilient on how do we generate the profit lines. As Marcos mentioned, the insurance business, the annuities business, even the Afore that usually is delivering a 12% return on equity, now it's delivering up to 15% return on equity, based upon all the positions that we hold and when you have a reduction in rates, you get a benefit on that.

So, all lines of business at the group are working well and supporting the our clients. This is our main goal to really been able to support our clients, and I also would like to jump into a consideration for you. Once we took the provisioning build up on June, I think it's worth noticed what should have been the numbers if we continue to do on a recurring basis. I think this is really an exercise on paper, but I think it shows the resilience of the bank. If it would continue with the current numbers that the group and the bank is generating, the return on equity for the group, without the provisioning line, would reach numbers very close to the 18%, and the return on equity for the bank also should sustain numbers very close to the 20%.

We already discussed the net interest margin, the efficiency cost, but another question that has come to us is what's going to happen with the return on equity for the group. I think it's worth mentioning that the buildup of the dividend is now sitting at the group, as Marcos mentioned. So, that is hurting the return on equity on the group, but that will continue to stay there until we get the go from the CBB--or CMBB or from our assembly to move the dividend from that. But the resilience of return on equity from the bank continued to be noticeable, as I mentioned to you, at a very, very high numbers, close to the 20%. Obviously, we will not reach the 20% return on equity for the group in 2020. I think we will try to be as close as we can. Yes, we will reach for the bank, that number, but not for the group and we are confident that all the other numbers that I've been mentioning to you, provisionings, the margin, cost, funding, the rate of growth also of the loan book has been also a good surprise.

If you strip away the government book, the loan book is growing close to 80%, good growth, close to 80% for the year. The mortgage book continues to be resilient. Credit cards, we are very careful with the credit card, but I think we could still see a small growth on that. Payroll loans that were flat and negative last year, started to build up to numbers close to 3% to 4%, and in the corporate and commercial, with all the withdraw of lines, you can see numbers growing on the corporate and the commercial well above last year's because there's no prepayments anymore. Those lines are now being returned, most of them to the bank. That's why you'll see also this buildup on the funding side.

So, overall, I think we entered this cycle with a very strong capital base. We just issue an AT1 paper into the market just to--as we have been telling you, we don't want to have any more Tier 2 on our balance sheet. We are reaching the same numbers that we had in the past, when we were not issuing T1 and only T2 on the composition of the capital numbers. So, Banorte's--the strength of Banorte is clear. We are proactively managing the pandemic. We have going on a one-to-one basis to our clients to sort it out the evolution of this pandemic. We are managing the funding, we are managing the margin, and also the way the bank has been working, as Marcos mentioned, during this pandemic show us that we are well ahead on the digital evolution in the market.

The NPS, just for you to know, grew substantially during this pandemic because of the opportunity of the relief programs and how we have been managing our clients, so I think the goodwill from our clients will also be a substantial part of how we manage the relationships with them.

So, with this, I end my remarks, and now we move to Q&A as we always do.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star (*), then one (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*), then two (2).

Our first question is from Ernesto Gabilondo from Bank of America. Go ahead.

Ernesto Gabilondo
Hi. Good morning Marcos, Rafa, and good morning everybody. My question is on

provision charges and reserved coverage ratio. We believe the NPL ratio was low, due to the reprogramming and the restructuring of the loan portfolio, and that's the only reserved coverage to be up to 200%. However, once we start to see NPLs showing up, do you have a target for the reserved coverage ratio?

And then my second question is on the relief program. As you mentioned in your presentation, individuals and SMEs represented 16% of your total loan portfolio. However, if including corporates, where do you see all the reprogramming or restructuring as a percentage of total loans? And linked to these relief programs, you mentioned that you have anticipated MXN 1.9 billion in write-offs and that you have created preventive provisions of MXN 3 billion. However, how comfortable are you for not needing more preventive provisions this year or even more in 2021, considering that the real impact will start to be seen after ending the relief programs and we still see uncertainty on how fast will be the reopening and the shape of the economic recovery for Mexico? On the other hand, if you have certainty on the potential provisioning for the year, would you be able to provide some kind of net income guidance for the year? Thank you.

Jose Marcos Ramirez Miguel
Wow! Ernesto, thank you. A lot of questions. Let me start by the three one. We feel comfortable with the information that we have so far. We won't need more additional provisions during the year, even for the next year. That's our target so far, with the information that we have, and we expect it not to move. And I will ask Rafa to go to the target of the coverage ratio, please.

Rafael Victorio Arana de la Garza
[technical difficulties] higher on the--based upon what we have been doing, but I think our aim and goal has always been from MXN 130 million to MXN 140 million. When you say that--I think it's quite important, Ernesto, to notice that what we mentioned about what's the effect of the relief programs. The first thing is that, since there's no evolution on the deterioration of all of the loans that are on the relief programs, what you start building up, and Marcos described this very well, that you see a disconnect from the accounting and the reporting from the really ongoing situation, is that you start to build up in addition to this MXN 4.8 billion, you start also building up additional provisioning because this deterioration is not happening as the book. So, you are not building up those provisions. You are reducing that. That's the number that I just gave to you, that MXN 735 million.

So, we feel very confident that this year, we have more than enough provision for that and with this additional month or two months that the government--the CNBV just granted to the bank, what you will see is that even you should be looking at November to see some numbers coming from the deterioration of the book. What I can give you is numbers that shows you what's the real effect on the deterioration of the loans that we already been seeing, based upon this observation that we are doing on the clients that are on the relief programs and we have seen that there's no more flows coming to their accounts, and that could hurt this, I would say, margin that we are writing on a monthly basis, based upon the methodologies. And it's extremely low. I mean, for the car loans, less than 0.6% of the clients are not really--should--could have been paid in the payment for the month. In the payroll, 1.1% related to the margin and credit cards, 1.1%. So, we still see extremely positive numbers on deterioration.

When you look at the payrolls and you see--I think we are on the safe side, saying that close to 13%, 14% of the payrolls that we pay are not receiving any more payments.

That's not related to the payroll loans, it's payrolls, okay? People that are losing employment and things like that. So that's another thing you are just losing deposits there, but you are not losing on the credit side. When you jump into the payroll loans, you have to divide it by clients that continue to be paid, clients that has seen a reduction on their salary, and clients that are not any longer receiving any money. We have that very, very well documented, and we don't see that we will need any more provisions also for the payroll.

Credit card has been a good surprise for us because, even on the relief program, they continue to pay, our clients. The mortgage book, as you know, the loan-to-value is close to 52% and SMEs, we have Nafin guarantees and dealing on a one-to-one basis. So, we are very confident that we are building enough provisions and all the action that we're taking will create another buffer for the provision in line. That's the first one.

The other ones that you say on the corporate and the commercial, there was no relief program from the corporate and the commercial, on that, there's no like stock payment of principal or interest. In that, what basically the commercial and corporate people did, and I will ask the commercial and corporate people to guide you to this, is basically provide enough liquidity with a new loan for specific purposes, okay? But we have René on the line, and he is the Head of Corporate, and he can guide us on this process. Go ahead, René.

René Gerardo Pimentel Ibarrola
Sure, Rafa and Marcos, thank you. Ernesto, basically, we have been working with our clients on tailor-made solutions and this is depending on the sectors and the specific client situations. We really didn't use these special relief programs for corporate clients, as they were mainly designed for individuals, and therefore, they were limited in the scope and the reach of the programs. So, this gives us an advantage. We will not see a significant pressure in October or November when the programs expire. This has allowed us to--after the provisioning that was made in June, to reach levels of NPLs of 0.3% and this after we fully provisioned a couple of nonperforming loans that we had in our books since 2019.

So, right now, what I can say is that we feel very comfortable with the work that has been done with the clients. We've reached more than 90% of the clients with these specific tailor-made solutions, so we do not see a deterioration of the portfolio this year. Of course, it will have to--it will depend on the opening of the economy. I mean there are sectors that are being hit harder. And if we do not see an opening of the economy towards the second half of the year, there are some sectors that will be hit the most in 2021. But for 2020, we feel very comfortable with the work that we've done, and we don't see any deterioration of the portfolio.

Ernesto Gabilondo
Thank you very much Marcos, Rafa, and René. That is helpful. So just a follow-up, do you think provision charges should normalize in the second half? But do you think they will continue to be higher on a year-over-year basis, right?

Rafael Victorio Arana de la Garza
Yes, on a year-to-year basis, it should be--if you take into consideration of the additional provisions that we build up, the usage of this provision is still to be seen. But yes, what we have seen is that if you look at the balance sheet numbers and you look at the numbers of the provision in last year, it was MXN 18 billion. Now we are sitting at the same number,

MXN 18 billion now. So if you see that the potential recurring deterioration of that number could jump to 20--25--MXN 20.5 billion or MXN 21 billion for the year, including this extraordinary provisions on that part, but yes, it will be a high number compared to the last year, but because of the addition of provisions, because the portfolio before the pandemic was behaving extraordinary well, as you can see in NPLs, on mortgages, car loans, credit cards, payrolls, commercial, and corporate.

So, I think we were quite diligent on providing our clients the liquidity and the peace of mind in order for them to work with them, and as René just said, on a tailored basis with a corporate and commercials, without any relief programs, we are tackling the liquidity issue that they have, so we are very confident that we are really doing a state of the art process in order to address every need of our clients during this process.

Ernesto Gabilondo
Thank you, Rafa, And still difficult to provide a net income 2020 guidance, right?

Rafael Victorio Arana de la Garza
I don't feel confident, Ernesto, to do this, but I will feel very confident by the end of the third quarter to provide you the guidance, but if you look at the first 5 months of the evolution of the net income, I think, can give you a pretty good idea what will be the number for the end of the year once we set up these provisions.

Jose Marcos Ramirez Miguel
So, we will do it in the next conference.

Ernesto Gabilondo
Thank you very much.

Operator
Our next question is from Jason Mollin from Scotiabank. Go ahead.

Jason Mollin
Hello everyone. Thank you for the presentation. You addressed a lot of my questions in what you have discussed, but I just wanted to understand two things that I wanted to get some color on, additional color. You talked about the decision to extend the loan forbearance program for a couple of--a couple more months. I understand, on one hand, you're offering more oxygen to your clients that need it to get back on their feet. We don't have a lot of certainty about when the reopening and how that will work, but on the other hand, this is prolonging the problem of identifying who's going to start paying or not. So, I just wanted to understand that decision to extend the loan forbearance program a little better, if you can give us your thoughts there.

And secondly, you had talked for years now about the targets--the longer-term profitability targets, 20% ROE in 2020 and clearly, if you exclude some of the impact or the provisioning impact on the--from COVID and everything we're living right now on the other line items, it looks like you would have been there. How does that impact--I believe that there were compensation objectives based on reaching these targets, are those being postponed till 2021? You mentioned that variable expenses should be coming down because that won't be a big part or if I understood, it, sounded like you were canceling variable compensation, but how should we think about that? And you guys have done a great job of getting the profitability up. No one saw COVID coming. How are you going to handle this in terms of incentivizing the people who really brought your ROE up to this level from levels previously well, well below? Thanks.

Jose Marcos Ramirez Miguel
Thank you, Jason. The first one, you are right. The way I see it, Rafa is going to give us more color, but the way I see it in the past, it was like a [unintelligible] for everyone, we send the medicine and now in the future, thanks to the tools and the analytics and all this, we can see all our clients, and that's different. We will send to each client different medicine. So, it's going to be another type of approach. Obviously, it's totally different. Internally, where--I don't know, the accounting, the everybody--it's more difficult to do it, but we have the tools to reach to a good end. So, you will hear how it works in the next months, but we are very happy with the way that we are doing these things.

The second, the target to profitability for the 2020. We're not giving up. Let's wait for the next--in these 3 months, and maybe we can change a little, but the objective is the same, no, so we are comfortable that the boat is big. We are a financial group, and still, we think that we can make it. Let's see, no. How to incentive people? Everybody's incentive is--we are surprised how the people is working. The home office, they are asking for new chairs because they are sitting the whole day. So, we are very happy with how the people is reacting to all these.

I don't know, Rafa, if you want to say something?

Rafael Victorio Arana de la Garza
I think what Marcos mentioned is clear. And Jason, obviously, if you look at where we are taking the expense line down, one is based--mainly bonuses are, tops going to be no more than 45% for the year, tops, and as you mentioned, there were specific goals related to achieve the 20% return on equity that we did on '19, but we promised on '20. So that's still to be seen, as Marcos says, but on the first, I think all bonuses have been reduced substantially for this year, and we will see how we reach that, but it's going to be a tough road, but we will aim--we will try to aim for it.

On the other thing that is your concern that we are just extending the pain. I would just start, and I will ask Gerardo, the Head of Risk, to guide us to what's the rationale for the second part.

Jose Marcos Ramirez Miguel
Go ahead, Gerardo. Please.

Gerardo C. Salazar Viezca
Thank you. Thank you, Marcos. Hello, Jason, talking about the consumer and SME loan book, and the extension in the enrollment program beyond two additional months. We have proceeded as follows: first, we have created one model for every credit type that we have within the consumer loan book in which we have separated the path to loan portfolio the ones that are currently enrolled and the ones that are not enrolled. We have created three clusters with good quality, low-quality, and medium quality loans. We have assigned a reserve of 1.3% up to 4% of the principal.

We have assigned a risk profile based on some parameters like the rating, internal rating, external rating, the VAT rate, the leverage, all the deposits, also dispersions, and some other SME parameters. We have assigned a probability of default, which is differentiated by each prototype: auto, mortgages, payroll, credit cards, SME loans.

After that, we have a forecast in which we are baking our additional reserves for 2020 and 2021 for each of the products that I just mentioned. We have implemented different strategies to preserve our loan portfolio quality. Strategies have gone from deferral and support programs, as you may know, and we are very confident that this extension of the forbearance programs will increase the number of cases from 610,000 to around 800,000, and the loan balance associated with those extensions in Phase 2 of the program will increase the MXN 131.7 million to MXN 155 million. That is a 3% increase in the loan book, which has been or who will be enrolled in the program and this is going to provide a jump from 16% of the loan book to perhaps 19% of the loan book. We consider this final, because we are reviewing, as Rafael was saying before, the status of each case to provide a custom solution to each and every one of them. So that's the way we're proceeding with these forbearance programs and the extension, which we consider will be final.

Rafael Victorio Arana de la Garza
Thank you. So, Jason, as you mentioned, it seems that we are just extending the pain, but, as Gerardo mentioned, we are not--this is not a general program. This is on a one-to-one basis, based upon what Gerardo just mentioned, which clients are really going to be in good shape in 2 or 3 months because the pandemic is extending more than expected, which are really going to be without any possibility. So, they are now in the recovery unit. So, this is not extending the pain. I honestly think that, as Gerardo mentioned, this is adding an additional caution to the buildup of this buffering provisions that we are doing and also, allowing extraordinary capacity for the recovery unit to go on a one-to-one basis to our clients.

So, on the other thing, as you mentioned, tough luck maybe for the bonus if we don't reach the 20%. There has been a reduction already further to the 45% for this year, but we need to continue to see how close we can come to the numbers.

Jason Mollin
Muchas gracias, thank you very much for the color.

Rafael Victorio Arana de la Garza
Thank you, Jason.

Operator
Our next question is from Tito Labarta from Goldman Sachs. Go ahead.

Tito Labarta
Hi thank you. Good morning everyone. I hope you are all well and safe. Thanks for the call. A couple of questions. One, following up on the provisions, just asking it in a slightly different way. If we exclude the extraordinary provisions in the quarter, your cost of risk was around 1.8%. Last year, it was around 2%, first quarter, 2.2%. So, barring any additional provisions if things get worse, is this sort of the cost of risk that we should expect between maybe 1.8% to 2.2%, more or less? Is that a reasonable assumption going forward?

And then my second question is just looking a little bit deeper on the insurance results. There's some mixed trends there, just to understand. I understand the seasonality in the quarter, but just looking on a year-over-year basis, we saw a huge increase in the technical results while the interest income, they come down. I imagine the decline in interest income was due to lower rates, but just if you can just go through a little bit deeper, just to understand the big increase in the technical results and is the decline in the interest income for insurance specifically related to lower rates? Thank you.

Jose Marcos Ramirez Miguel
Thank you, Tito. Yes, the way we see things so far, we don't have the magic ball, but yes, it will go from 8.1--1.8%, sorry, 1.8% to around 2.2%, 2.4%. Around that is the way we see things right now and Rafa, go ahead with the next one.

Rafael Victorio Arana de la Garza
Tito, thank you, no--yes, the running rate of cost risk always has been from 1.8% to 2.2%. Even at the beginning of the year, we guided before the pandemic that we will be moving from 2.2% to 2.4%. So, I think the running rate should be 2.2%.

What is very important to notice is what you mentioned. We are entering this cycle with a record 1.8% cost of risk without the extraordinary provisions. So, that is also giving us room to manage this. On the insurance business, as you mentioned, the interest income grew 25% and 28% annually, as you mentioned, because mark-to-market valuation of the positions that we have. I think also what is quite important for the insurance business that continues to do well, even if there has been a reduction on the traditional products that we usually try to accompany with an insurance like mortgages or car loans on that. Also, the technical reserves have been going down, because there has been a less robberies, less crashes, because people are not driving on that, and how exposed we are to the health side. We are very, very low, have very, very low exposure to the health side, so the insurance business will continue to be a good story through the remaining of the year, but basically, it's the mark-to-market valuation of the positions.

Tito Labarta
Thank you. It is very clear. Thank you.

Jose Marcos Ramirez Miguel
Thank you, Tito.

Operator
Our next question is from Thiago Batista from UBS. Go ahead.

Thiago Batista
Hi guys. Thanks for the opportunity. I have--the first one is a follow-up on the asset quality. In the stress scenario, you showed that NPL ratio should achieve 2.5%, more or less in the second queue. So, if you can comment a little bit on what were the main mock scenario assumption that you used it in the simulation and also, how much more provisions would be required in this scenario? And finally, in this topic. Why this peak of 2.5% would be, let's say, a little bit below the peak that the NPL achieved in the financial crisis? So, this is the first question, and the second one, if you can comment about the bank's view on the possible pension reform in Mexico. So, what would be the main impact for Banorte? So, if you can give us a color on this reform.

Jose Marcos Ramirez Miguel
Rafa, please go ahead.

Rafael Victorio Arana de la Garza
So, Thiago, if I hear you well, because there was some noise on the line. Your main concern is the--if this provision is that we just build up, based upon what they have built up. As Gerardo mentioned, they are built up on a case-by-case basis on a product-by-product basis, based on the expected loss and also all the information that we have. And also, we stress the scenarios in a very important way. I think when we are talking about that on the second quarter, we expect the cost of risk to reach almost to 4%. You are really stressing the book at a substantial level. Remember, when we did a very, very aggressive stress test to say that if we could support the capital numbers of the bank, we even jumped the provisions up to MXN 42 billion and the core Tier 1 was 11.2%, 11.3%.

So, we are very confident on these numbers. I mean, we are doubling the--more than doubling the cost of risk and when we see the peak on the second quarter of '21. So, we are confident on that. We pride of how the recovery unit, the risk people, the product people have been really tackling this on a very detailed and dedicated way, so we don't see any hiccups on this. I mean we don't know exactly what the pandemic is going to do, but the country is now reopening and starting to move forward, so slow but moving forward, still horrible numbers coming from economic growth, but for the near future look a little bit better.

So, if you ask us that NPLs are good enough for what we are provisioning and NPLs could be 2.4%, 2.3% for the end of '21, I think that numbers are already being considered on the evolution of the provision and on the risk analysis that we do.

Gerardo C. Salazar Viezca
This is Gerardo. Thiago, I will add to what Rafael is saying, that we have contemplated two scenarios. One is a stress scenario, in which recovery takes long and the other one is an extreme scenario, in which we have a recovery in an L shape. So, we have considered even the extreme scenario, and we feel comfortable, based our macro assumptions, like inflation, employment, potential growth, and also what it is required from us, given the loan profile that we have and all the portfolio of risks that we have to mitigate.

Rafael Victorio Arana de la Garza
I think what Gerardo mentioned is quite important because if you look at the mortgage book, that is a fully provided book with a loan-to-value and you also look at the government book that is under the trust characteristics of the book, a very safe and secure book. More than 40% of the portfolio, plus in addition of the SME of the Nafin guarantees, I think the portfolio has a lot of coverage already based upon the type of business that we are in.

Thiago Batista
No, perfect. Perfect and the second question--I'm not sure if the line is better now, but on the pension reform in Mexico, what is the possible impact for Banorte?

Jose Marcos Ramirez Miguel
Rafa, go ahead.

Rafael Victorio Arana de la Garza
The pension reform looks pretty well from the standpoint that workers will have a better pension on that. Still, we need to see what's going to be the effect on the fee side, what

exactly going to be the detailed ruling for this. I think on the overall numbers and picture, it looks in the right direction. We need to look at the details and remember that we are the largest pension company, so, we have already a very large economies of scale. So, and therefore, if you look at the numbers that we are now returning on equity, 15.3%. Before it was 12%. The Afore has been undergoing a very detailed restructuring, being--becoming more and more and more efficient, so I think we have the scale to support this reduction. We need to look at the details. In the overall, we will have a lot more assets under management to manage. So, I think we still need to see the detailed ruling of this, but on the overall, I think it was needed, it's a step in the right direction, but we need to continue to really accompany this with a much more efficient move that we have taken in the past, but I think we are very confident of the evolution that the Afore company is having up to today.

Thiago Batista
Thanks a lot.

Jose Marcos Ramirez Miguel
We have received a question from Rodrigo Ortega that basically was the same question that we just answered. So, Rodrigo, if you have any further questions let us know, but I think it was basically the same as Thiago.

Operator
Okay. Our next question is from Marcelo Telles from Credit Suisse. Go ahead.

Marcelo Telles
Hello Marcos. Hello Rafa. Thanks for the opportunity to ask questions. I have a couple of questions here. The first one, there seems to be a disconnect, right, between your speech and what is happening on the ground in Mexico, right, when you look in terms of the amount of job losses that you've seen since the beginning of the pandemic. It's been more than the first 2 years of job losses post-COVID crisis and in your scenario for provisions, you seem to consider like kind of the way crisis as a proxy for that. But it does look like that Mexico is heading to a significantly much worse environment. So, what is the risk that maybe overoptimistic on your cost of risk assumptions going forward? And just putting some numbers, right? If you look, based on the 16% of the loans that have been restructured, that's about MXN 125 billion. If you consider your 2.2%, 2.3% cost of risk for the next quarters, we would probably talk about maybe like MXN 30 billion, right, in terms of provisions, vis-à-vis almost MXN 125 billion of loans that are, let's say, being--having forbearance terms or being restructured, so which is just 1/4 of it. So, how can you be so sure that this will be enough?

And my other question is regarding your liquidity position, you did improve from 120% to 151%, but on the other hand, you seem to have to tap still a very significant amount of emergency lines from Banco de Mexico. I was looking at your numbers, it looks like the amount of credit lines from Banco de Mexico are almost 4x higher than what they were a year ago, and there was a significant increase since the fourth quarter. And what is the risk that this poses to your margins down the road once those liquidity, emergency lines, they have to be paid off and you have to replace those lines with a lot more expensive lines? And what's your strategy to replace those lines down the road? Thank you.

Jose Marcos Ramirez Miguel
Thank you, Marcelo. Good and tough question. First, we think that we have something

like documented optimism, that we are collecting all the data. We can see what the clients are doing, and we know Mexico as a bank maybe better than a lot we know them. So, I will ask Gabriel Casillas first to give us like a frame of computing, which we are moving, the worst cases scenario and the best cases scenario and from then, we are taking the data, and that's why we are kind of optimistic, no. Gabriel, are you there, please?

Gabriel Casillas Olvera
Yes, of course. Thanks, Marcos and thanks, Marcelo, for your very insightful question. It's very true, what you're saying, employment situation is not what we're seeing in the unemployment rate. As you know, it came up from 3.2% to 4.7% and we have actual declined a little bit, but I am pretty sure that as you've seen the numbers, if you take a look to the employment report, there's a lot of people now available to work. That is saying that they don't have a job, but because they say, they're not looking for a job, they are not part of the unemployed. So, if we add them up, unemployment rate could be right now around 20%. So, this is alarming, but 2 things that I would like to say about these 2 things. On the one hand, unfortunately, if you take a look to what has happened to these people that have unfortunately lost their employment situation, the ones that have lost it are pretty much like 75%. People are earning 1 up to 3 minimum wage--times minimum wage. In this context, as you know, in our loan book, we do not have a lot of those people that unfortunately lost their jobs. So, that’s on the one hand and the other hand is very important is that our analytics area and risk management and the product area have been working, as Rafael mentioned, in a case-by-case scenario, pretty much taking whether they're getting the--they continue to gain a little bit salary or those kind of things. So, I think definitely, as Marcos was saying, I think this is the documented optimism in this context.

Rafael Victorio Arana de la Garza
Marcelo, I think what you say is--I think if you were sitting and trying to manage an institution like Banorte, you can look at it either in three ways. The first one, this is going to be a disaster, nothing is going to happen because there hasn't been enough support from--like in other parts of the world, in order to support the SMEs of the companies of that, so the burden is on the banks on that. So, in that way, you also have to understand how the composition of Banorte is. When you look at the payrolls, and this is linked to the payroll loans, we didn't have any growth last year on payrolls basically because there were so many layoffs from the government that stopped completely, but close to 55% of our payrolls are coming from the civil servants. So, that number will stay there, and will continue to do so and also link it to the payroll book, okay? So, that's a big difference on that part.

We know that the SMEs are going to suffer on the payrolls. We're already tackling that, but not many of those have a payroll loan with us, so we will lose some deposit lines on that. I'm sure of that. Job losses will continue to expand. It depends on how long the pandemic continues to go. I mean, a big effort has been ongoing on the private sector to try to stay with employments as long as they can. And we already see some very good recoveries in the central part of Mexico and in north part of Mexico that are linked to the NAFTA, to the new NAFTA deal that is creating a better image of what's really going to be the unemployment rates going forward. Not today, going forward in the coming months.

Also, tourism is becoming more open in Cancun and also in Cabo, obviously, at levels that are quite low compared to the usual levels of that, but that also is coming. There will be some setbacks on that. I'm sure it will come to that. So, when we are looking at the cost of risk, we are not staying at the 2.3%. We are picking up to the--close to the 4% on the second quarter of '21, but also looking at the numbers of the recovery unit on how these contention plans are working and how these are bolstering our capacity and also our buildup of NPL formation, I'm confident of what--also what Gerardo mentioned of what we have been doing.

Just to give you of how detailed this managing of the book is going. On a branch-by-branch basis, on a client-by-client basis, we are targeting who needs to call, how is going to follow that, when it goes to the recovery unit, when you start doing additional restructuring issues on that. So, we are fully on motion on that. We know the growth is going to be coming a lot less than the past years, but the most important piece that we are now measuring our people is to keep our book healthy and online. Obviously, the picture is not pretty at all, but the picture is getting better than it was a month and 1.5 months ago. So, this is what is. If you ask me, if this is going to be good enough, a colleague of you, I will not say his name, but he--just the other day, told me, the building up of provision is art, but it's also -- is becoming more an art than a science because you have to really see how the market and how the different parts of Mexico behaves on this reopening on that part.

So, if you ask me, is that going to be good enough? We hope it's going to be good enough. We are confident it's going to be good enough. But if we need to build more provisions, we will build more provisions on that, because we have the strength on the capital base. We continue to deliver profitable numbers on a month-to-month basis, so we have enough caution on that.

On the liquidity side, let me be very clear. We are not drawing any more lines than anyone. If there's a facility to be taken at a better cost than I can go into the market, I will take it, but not because I need it, but because it's an opportunity cost if I don't do that. But I'm not taking any more than that. We are not taking any advantage of the buffers that the CNBV offer on the capital ratios or on the liquidity side. Our liquidity, as you mentioned, it stops, and when we issued this $500 million AT1 was because we are looking at a very good pipeline of companies close to $800 million that need to be funded that are linked to the NAFTA deal, and we are confident on that.

So, we are not building up liquidity based upon facilities given by the authorities. If they are there, we will take them, but we are building liquidity based upon our funding, our capacity to fund our clients, our capacity of our retail branches to build up demand deposits, that is growing 20%.
So, believe me, we are not taking advantage if--the only way we will take an advantage of that is if it's--the price is better than we can get into the market, but not because we cannot get in that into the market.

Gerardo C. Salazar Viezca
[unintelligible] what Rafael is saying regarding liquidity.

Rafael Victorio Arana de la Garza
I'll let Marcelo, and then I'll let Gerardo. Please, Marcelo, go on.

Marcelo Telles
Yes. I just want to say, I mean, that's exactly my point because the--you guys had to tap the market and still, if you look at the amount that you had to raise in terms of credit with Banxico vis-à-vis the growth that you had in your liquidity coverage ratio, it seems that you really needed that extra liquidity to close the gap. Given that perhaps have a bigger like

duration mismatch or a bit assets and liabilities and my concern here is if this is certainly a cheaper but temporary sort of instrument. It doesn't seem--the point that I make is that the -- all the liquidity that you took didn't lead to a significantly higher liquidity above that. Actually, your increase in liquidity was probably less than the amount that you got from Banxico because you probably had a gap that you had to fill. And my question here is that if this represents a potential downside to market, if you can also mention how do you get out of those liquidity mechanisms? Are they like 1-year term? 2 years? Or maybe you can hold on to them for many years? And what is the cost associated with those?

Rafael Victorio Arana de la Garza
No. Marcelo, I can tell you this, we can get away from those lines today, and there will be no issue on our liquidity numbers. There will be a small reduction on that and the pipeline in dollars will be more than funded with the last AT1 that we just issue into the market. We are doing everything on our own. If there's an advantage to be taken, we take it, but not because there's a necessary tool for us to keep operating.

And I will ask Gerardo, if you want to add something?

Gerardo C. Salazar Viezca
Sure. Sure. Hi Marcelo, I will add that core and sticky deposits, it's the main ingredient in this liquidity that Banorte has. We have to report to the Board of Directors the liquidity coverage ratio with and without Banxico's volatility waivers. If you do that math, you will find out that no more than 2% of this 150.8% on average liquidity coverage ratio that we had on June is explained by those waivers. So, I'll be happy to give you the numbers whenever you see fit, because...

Marcelo Telles
Yes. I'm not talking about the waivers. I'm talking about the actual liquidity that was taken.

Gerardo C. Salazar Viezca
Yes. If I sum up all that is--there's few things. One, the volatility waivers; two, the free up of the DRM, Depósitos de Regulación Monetaria; and third, the subasta of dollars, we could get rid of them, and we will be well above 140%, 145%. We don't have any worries around that, but we have been professionally managing those deposits. The liquidity has been built by current sticky deposits and the structural balance sheet. So, I'll be happy to show you those numbers.

Marcelo Telles
Yes, we'll be good to take that off-line because the numbers just don't reconcile but happy to follow up. Thank you.

Rafael Victorio Arana de la Garza
Thank you, Marcelo. As always, we're more than happy to have and provide you all the necessary information that you require to do so. But believe me, there was a big mandate for us. The capital has to be very strong. Liquidity has to be primed in order to support our clients and if there was a facility to be taken, that could be cheaper to than what we can get into the market, we will take it not because we need it, because it will be a fool for most not to take that opportunity.

Marcelo Telles
Thanks, Rafa.

Rafael Victorio Arana de la Garza
Thank you, Marcelo.

Operator
Our next question is from Brian Flores from Citibank. Go ahead.

Brian Flores
Hi, Good morning. Thank you for the opportunity to ask a question. Just a quick follow-up on what you're seeing on the SME portfolio. Based on previous comments made on, I think, after the first quarter, we saw a little increase on the guarantees provided by Nafin. Is this something originated because you're pursuing to increase them? Or because you are making some guidance in that particular segment?

Jose Marcos Ramirez Miguel
Rafa, please go ahead.

Rafael Victorio Arana de la Garza
Look, let me go to the numbers. 3.8% of the total book is SMEs. Of those, more than 53%, 54% are under Nafin guarantees. We are withdrawing more guarantees, as you mentioned, in the last three months, by using that facility in order to keep our book clean, but not because it's something that we already paid for that. And Nafin has been very supportive of the guarantees, so we are very pleased of the way Nafin has been behaving during this process supporting the client.

So, as I mentioned, SME is a portfolio that we are actively managing on a one-to-one basis, visiting clients, offering them possibilities, looking who's going to be gone forever, who's going to be needing more time. So, SMEs, and remember, we have not grown the SME book for the last year and this book, okay? So, and just for you to see, Nafin just announced a tourism program in order to support those small companies that are linked to this tourism side. So, I think Nafin is moving in the right direction and helping SMEs in the right way.

Brian Flores
Thank you, Rafa, and just as a follow-up. Is this a trend? I mean, do you expect to keep capping on results? The Nafin, is this something we expect to keep increasing? Or are you comfortable at the current levels?

Rafael Victorio Arana de la Garza
No. I think we will continue to withdraw more guarantees if we need it, but I think we are reaching our level. We moved from MXN 50 million, withdraw from MXN 90 million, MXN 110 million at the peak. So, I think that's what we are saying on that part.

Brian Flores
Okay. Thank very much.

Rafael Victorio Arana de la Garza
Thank you.

Operator

Our next question is from Nicolas Riva from Bank of America. Go ahead.

Nicolas Riva
Yes. Thanks very much for taking my questions. I have a couple of questions. The first one is a follow-up on a prior question on the pension reform bill. So, if I think about the impacts for the bank and for the holding company for the group separately, you already mentioned the positive impacts for the holding company, basically through the Afore, through higher contributions into the assets under management, which, of course, is going to be good in terms of fee income for the Afore. For the bank specifically, I would imagine there's going to be a negative impact on personnel expenses from the higher contribution, from contributing an additional 1%, I believe, per year through the next 8 years. Is that, I mean have you assessed--have you quantified in a way, the negative impact on the bank from those higher personnel expenses? I would imagine it's going to be then a bit less than 1% of your bottom line per year, but any color on that would be helpful.

And then the second one, Rafa, you mentioned in your initial remarks about the recent issuance of another perpetual bond. Can you talk about the use of proceeds of this $500 million that you raised, if you plan to redeem any existing debt? And there was one particular comment that you made, Rafa, in those initial comments, which was that the idea would be not to have any more Tier 2 debt. I would imagine this applies to the legacy Tier 2 debt from the acquisition of Ixe, for example, but not to the 2031, that I would imagine that you're going to continue to have outstanding, and also, if you can explain us one more time, what's the rationale maybe for having so much AT1 capital? I mean the optimum level would be for you to have about 1.5% of risk-weighted assets in these AT1s, of course, they are not cheap for you to issue them. If you can explain to us, yes, why you think it makes sense to have all this much AT1 outstanding? Thanks.

[technical difficulties]

Did you guys hear my questions?

Jose Marcos Ramirez Miguel
Yes. Yes, it was a cut off, but I think I got the whole picture. First, talking about the pension reform bill. We are very happy with that. It's a proposal. So, let's wait a little bit, and then we can discuss it, but so far, for the country, it's very good and whatever happens to the country and is very good, is good for us. We want to reduce a little bit the commission, so it's good. We will negotiate, obviously, but we're very happy with what is going on and we need to wait a little bit what happened with this proposal, no. That's all we can say right now, and the second one, the AT1, please, Rafa?

Rafael Victorio Arana de la Garza
Yes. In addition to what Marcos says, what's going to be the effect in the coming eight years that they are just announcing that without any specific ruling of how you have to build up more contributions to the fund. We haven't calculated that, but honestly, I don't think it's going to be a material effect that it can be counter--there should be countereffect by many ways. Like for instance, once with the pandemic, what you have seen is that you need a lot less physical space that you need to have in the past. So, there's ways that we can balance that on that, but in general, I think it's going to be good, and remember one thing, Banorte has the largest Afore. We have the largest economies of scale. So, honestly, what I think about this reduction in fees is more consolidation is coming and we're going to be benefit from that.

On the other part, the AT1, let me just give you a little bit of history about this. Banorte has always been having a mix of Tier 2 and Basel II and core Tier 1 that it reached, on the past, 31% of Tier 2 compared to the total cap. If you look at the numbers that we are reaching now with a completely different core Tier 1, it's simply the same numbers. We are below that. We are 20--29%. Okay? So that why we don't like that T2 is exactly, as you mentioned, the legacy of the Ixe is extremely expensive. We did some tender offering last year. We continue to try to get rid of those Basel II. We don't want to fragment AT1s and AT2 on the capital numbers. AT1s are much more efficient for us, based upon the strength of our capital base.

The use of proceeds for that is basically a funding on the dollar book. These are already being matched by the money in dollars for companies that have flow in dollars are linked to exports. So basically, what you do is you take a funding in dollars well below your cost of capital, and you use that to fund that on a dollar-to-dollar basis. So basically, you are issuing capital below your cost of capital in dollar terms that are already being fully matched with demand in dollars for the clients. That's the rationale.

In addition to the liquidity, because AT1s, as you know, they don't have any issues in liquidity. Tier 2, they start to lose efficiency long before the call day. On the AT1s, on the perpetual characteristics of this one, you don't need to add specific liquidity assets when the call day is close. So, it helps you on the liquidity. It helps you on building up your capital. Your total cap is much more efficient on the funding side. As you know, this goes against return earnings and when you look at the returns that the bank is providing on the capital base above the 20%, I think it's an extremely good use of proceeds when you deploy that into the market.

Nicolas Riva
Okay. Thanks very much Rafa and Marcos.

Rafael Victorio Arana de la Garza
Welcome.

Jose Marcos Ramirez Miguel
Thank you.

Operator
Our next question is from Carlos Gomez from HSBC. Go ahead.

Carlos Gomez
Thank you very much and thank you for extending the call beyond normal level and first of all, congratulations to Tomas, to his first quarter conference call as Head of IR, and we wish him very good luck.

Two very minor questions from us. The first one, also on the pension reforms and we wanted to know what possible impact it has on your annuities' business, not so much on [unintelligible] but on the annuities. And second, on the margin, you focused on the impact on the first half as a whole, but the reality is that your NII in the second quarter was 6% below the first quarter. How confident are you that you will not see that decline further in the second half? Thank you.

Jose Marcos Ramirez Miguel
You go ahead Rafa.

Rafael Victorio Arana de la Garza
Yes. I mean, the annuities business, Carlos, and thank you for asking because I think we are very proud of the evolution of the annuity business. As you know, we just bought a portfolio from another company because we are the largest one. That gave us in other income, a benefit of 110--close to MXN 110 million and the annuities business is becoming more and more a key driver of the profit of the bank, with return on equity above the 27% and a very good opportunity that we are not having in the annuity business is that we are also lending to our clients, baking the loan with the annuity. And the portfolios that we are buying, they were very underpenetrating on that part. So, the margins to be made on these portfolios are quite significant. So, the annuity business will be really a stellar unit for us. It already is and we'll continue to grow nicely on that. So, nothing to concern on that. I think on the other side, everything is going in the right directions. We have the first position in the market. We are building up profitability. We are building relationships with our clients, good margins on that.

The other part is that the margins. The margins--when you look at the reduction on the spread on the book on a year-to-year basis, our book has come--when you do all the overall book from 11.75% on May '19--on June '19 to 10.69% on June '20. So, you see that there's a lot of resilience based upon the fixed book portfolio, but the most important piece that is related to the margin is that the cost of funding has dropped substantially from close to 3% last year to 2.2% this year on this same time frame.

Another big number that dropped and is helping us on the retaining on the resilience of the margin is that the funding that the treasury needed to fund the Interacciones book that peaked at MXN 123 billion, now it's only close to MXN 16 billion, and the cost that was past year was 7.5% for this part of the group and now has dropped to 4.49%. So, all this managing on the funding side and also the resilience that we have on the fixed rate portfolio and also on the liquidity premium that now you are putting on the spreads on the book, I think we can sustain for the bank a reasonable margin around 5.8%.

Carlos Gomez
Thank you very much.

Operator
Our next question is from Natalia Corfield from JP Morgan. Go ahead.

Natalia Corfield
Thank you everybody for taking my question. It's actually a very simple question. I am looking at your Other Income in your financials. It has increased quite substantially quarter-over-quarter and I just wanted to know what was the main driver of that?

Jose Marcos Ramirez Miguel
Natalia, thank you very much. We were waiting for that question. The first question. So Rafa, go ahead.

Rafael Victorio Arana de la Garza
Natalia, if you look at the components of that, the Other Income, and it's quite important to look at the Other Income and compare it to a year-to-year basis, taking away the

extraordinary like the IMB and this part. The main number that you see on jumps on that is--has related to a benefit that is concerned on the tax side, okay? And this is basically related to the inflationary numbers. When we did the provisioning for the last year, we aim to have an inflationary rate of 3.2%, and it came at around 2.8%. So, this basically, we overprovision that. So, we are pulling those provisions away now that we have the go from the fiscal department.

[technical difficulties]

Unknown Speaker #1
Have a good weekend.

Unknown Speaker #2
Thanks, you too. Next week, on the 31st.

Unknown Speaker #1
Yes.

Unknown Speaker #2
[unintelligible] you too?

Unknown Speaker #1
Yes.

Unknown Speaker #2
[unintelligible] too?

Unknown Speaker #1
Yes.

Unknown Speaker #2
Yes, I will see you.

CONCLUSION

Operator
This concludes our question-and-answer. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.