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Monthly Report on Banking and the Financial System

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Banking and the Financial System

Credit to the private sector reduces dynamism due to credit to companies

In November 2017, the outstanding balance of credit loans granted to the private sector by commercial banks grew at a nominal annual rate of 10.6% (3.7% in real terms), 1.9% down on the rate seen in the previous month (12.5%) and 6.4% below the reading in November 2016 (17.0%). This result was due to the slowdown in lending to companies, which decreased from 15.7% in October to 12.1% in November, while growth in mortgage loans also slowed, going from a nominal annual rate of 9.2% in October to 8.9% in November. Consumer credit remained unchanged with respect to the previous month, with a nominal growth of 8.2%. The stability of consumer credit could be associated with the favourable performance of sales during “El Buen Fin” (Mexico's version of Black Friday), however, the slowdown in various sectors of economic activity and higher inflation negatively impacted the performance of the other segments. In the coming months, the perception of a less favourable environment for investment and consumption could generate greater caution in the financing decisions made by households and businesses.

Growth in bank deposits decelerates due the slow down of its two components

In November 2017 the nominal annual growth rate for traditional banking deposits (demand + term) was 11.6% (4.6% real), 1.6 percentage points (pp) less than that seen in the previous month and 3.2 pp less than the nominal rate reported in November 2016. During November 2017, growth in the two components of traditional deposits slowed down, albeit at a different pace. Thus, demand deposits experienced a more significant reduction, reaching a nominal annual growth rate of 11.5% (vs. 14% in October), while term deposits showed a slight reduction in their nominal annual growth rate, which was 11.7% (vs. 11.9% in October).

The lower dynamism seen in the growth rate of demand deposits was the result of the slowdown in deposits associated with non-bank financial companies and intermediaries. The lower growth of demand deposits could be associated with the exit of balances accumulated in foreing currency (FC) as a result of the official capital repatriation programme, in order to invest the resources according to the purposes foreseen to obtain the fiscal benefit, and the reallocation of resources towards longer term instruments. In the case of term deposits, although deposits of companies registered a recovery, this was not enough to offset the slowdown in dynamism in the rest of the segments.

New tool to analyse conditions in the credit card market

The Bank of Mexico made available to the public an online tool for dynamic analysis of the credit card market, whose goal is to help promote competition among financial service providers and supply users and analysts with data for decision making. This initiative complements the tools that analyse personal loans, payroll loans and auto loans, released by the central bank since 2017.

The credit card analysis site provides information of different variables such as the number of cards, interest rate, credit limit, reason for use, payment behaviour (customers who pay all of their monthly card bill and those who do not), and for different types of cards. The analysis can be carried out both for the whole system and for specific regulated institutions and has different levels of aggregation and segmentation, among which the most relevant are: credit limit, card type or type of customer.

Banco de México modifies the definition of monetary aggregates and introduces new indicators

With the aim of improving the quality of information on monetary aggregates, adhering to the guidelines laid down by the International Monetary Fund and generating internationally comparable data, in December 2017 Banco de México carried out a methodological review of the Monetary Aggregate statistics. This new methodology retains a narrow monetary aggregate (M1) composed of liquid instruments held by resident sectors, and three other large monetary aggregates: (M2) that adds to M1 term instruments held by resident sectors; (M3) which, in addition to M2, includes the securities issued by the federal government and the IPAB held by resident sectors; and (M4), composed by all M3 instruments in hands of non-residents. The aggregate M1 does not change with respect to the previous methodology, but the aggregates M2, M3 and M4 present modifications with respect to the previous statistics, which are due to the reclassifications of financial instruments between one aggregate and another, or to the exclusion of other instruments (for example, the balance of savings funds for retirement and housing, which are not part of the new definition).

Secondly, the new methodology created indicators called "internal financial assets", which include the instruments contained in the monetary aggregates plus other instruments that, given their nature, are not part of these, such as equity instruments or savings fund accounts for retirement. With this new methodology, four new indicators are defined: (F1) constituted by internal financial assets held by resident sectors, excluding equity instruments, (F2) that adds equity and hybrid instruments to F1, which are held by resident sectors and are issued by institutions that have registered offices in Mexico. The FNR aggregate that is made up of instruments referred to as being in F2, and that are held by non-residents, and aggregate F, which is the sum of the aggregates F2 and FNR.

The third change is the reclassification of financing statistics to put repo transactions under an economic definition, where the sector that holds the security always keeps it on its balance sheet, even when using it as collateral to receive financing through a repo transaction. This contrasts with the previous approach, in which repo transactions were taken in under their legal definition, which implied the transfer of ownership of the underlying security. Due to this modification, there is a re-

sectorisation of the possession of these instruments and the sector that grants the financing. It should nevertheless be clarified that this modification does not affect the balance of financing received by agents through the issuance of securities.

Mortgage interest rates in line with long-term rates

At the end of 2017, the weighted average interest rate for mortgage loans was around 10.4% in annual terms. Between January and December last year, this indicator increased by 68 basis points (bp). However, in cumulative terms for the whole year this represented less than half of the 138 bp that the monetary policy reference rate increased by over the same period.

In the monthly report for July 2017, we forecast that the mortgage interest rates would end the year at levels close to 10.5%, which they did. This is due to the high correlation that exists between this indicator and the behaviour of long-term rates. In particular, the 10-year bond (M10) increased 24pb between January and December 2017, going from 7.41% to 7.65%.

The limited trasmission channel of Banco de México’s funding rate over mortgage rates, maintains favourable financing conditions in the housing market. Consumer confidence, which had been in negative territory between November 2016 and July 2017, actually began to grow over the second half 2017. In particular, the confidence index for buying housing recovered notably in December 2017.

Consumers seem to readily assume that Banco de México's benchmark interest rate has little effect on the mortgage loan market, since the improvement in expectations would be expressing the behaviour of long-term rates with greater emphasis. These rates could be placed at 7.9% in mid-2018, but we expect them to stabilise at around 7.7% by year-end. Mortgage rates could therefore be around 10.9% by the end of 2018.

Financial Markets

Financial market volatility picks up

During the first days of February there was an upturn in the volatility of financial markets, after an environment of more than 12 months, which had been favourable for risk assets. The trigger was the US employment report for January, which showed a 2.9% YoY growth in salaries, higher than expected and the highest level since the 2009 financial crisis. Given the latter, higher inflation expectations were generated and, therefore, prospects of faster increases in interest rates from the Federal Reserve, as well as higher yields along the sovereign bond curve. All this was reflected in significant falls in stock markets.

While volatility increased for most classes of assets, stock markets recorded significant changes in price. Between 1 and 5 February, the VIX index went from 13% to 37%, which was reflected in a 6.1% drop in the S&P500. This slip was steeper than the 4.92% registered on the global stock benchmark (MSCI World) and the 3.15% on the emerging markets benchmark (MSCI EM). With this movement the North American markets practically eliminated the gains obtained during 2018. On the Mexican stock market, the fall up to February 6 was 2.5%. In the US government debt market, the 10-year maturity yield went up to 2.8% the same day the employment data for January was released, reaching a level not seen since the beginning

of 2014. In Mexico, the long-term government bond yield experienced moderate rises of around three basis points, which placed it at levels of 7.63%.

Foreign exchange markets were affected the least. Timely communication of central banks, in the sense of maintaining their focus on gradual increases in interest rates in this environment, meant that the incipient "flight to quality" that had been registered gradually petered out. In fact, between 1 and 5 February, the US dollar appreciated by 1.5% with respect to emerging markets currencies and 1% with respect to developed markets, while the Mexican peso depreciated by 2.4%. By mid-February, currency appreciations of the US dollar against emerging and developed markets had practically disappeared, while for the Mexican peso, depreciation fell to 0.8%. Even with this decline, the Mexican peso remains as the best performing currency so far this year (4.84%).

In a context of greater and more widespread global economic growth, the recent episode of uncertainty has shown itself to be temporary and influenced by technical issues. However, it will be relevant for volatility to return to levels more in line with their long-term average and henceforth toremain as a real indicator of the risks that exist in the environment.

While this argument has relevant elements, it is essential to put in context what happened in recent weeks in order to better understand it. This episode takes place within the framework of an unusual period of low uncertainty and high liquidity. In fact, the VIX index that measures the future volatility of the S&P500, an important US stock market benchmark, remained below its average over the last ten years for 14 consecutive months. As a consequence of this lower volatility scenario, along with the liquidity conditions maintained by central banks, the stock indexes reached new historical highs and registered strong valuations that tended to move away from their fundamentals. By way of example, the Dow Jones index, which follows the performance of the 30 leading stocks on the US stock market, recorded a new historical high more than 70 times during 2017.

This context led some investors to look for new instruments linked to low levels of volatility with the expectation of obtaining higher yields. When these investors sought to undo their positions, they amplified the adverse effect on the markets, increasing the VIX volatility index from 20% to 37% over the last few hours of operation on 5 February. From these arguments it is possible to affirm that, even though the catalyst was the employment report, this new abrupt episode of volatility is more associated with technical market movements than with economic fundamentals. This statement is also based on two factors: First, the global economy shows more solid and widespread growth rates across all geographies. In fact, the International Monetary Fund recently revised its growth forecast upward for 2018, from 3.7% to 3.9%, a rate that has been practically unseen since 2011. Secon, recent statements from central banks suggest that, even in the current environment of greater economic growth, this new episode of volatility will not lead them to change their gradual approach to interest rate hikes, one of the main fears of market participants.

Even though these episodes generate uncertainty among economic actors, the recent markets corrections may have certain favourable elements, since it reminds investors the relevance of correctly integrating volatility movements in prices. Especilly because we expect future valuations to reflect economic fundamentals rather than unusual periods of low volatility and high liquidity.

Regulation

Adjustments to the transitional regime to meet the capital requirements for operational risk

On 22 January the CNBV carried out adjustments to the applicable framework for complying with the operational risk capital requirements for banks with an average monthly loan portfolio below 30 billion UDIS (€ 7,8 billion approximately).

Ammendments to the Law on Financial Discipline

On 30 January, the Law on Financial Discipline of States and Municipalities was adjusted on the one hand to address issues deriving from the implementation of the regime it has already established, and on the other to introduce operational allowances for natural disaster responses. It is worth remembering that the Law passed on 27 April 2016 introduced rules for budgetary discipline, a mandate for the contracting of debt under the best market conditions, as well as a registry of loans contracted by sub-national governments and their agencies.

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