Banks

Monthly Report on Banking and the Financial System

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1.1. Banking and the Financial System

Business loans continue to underpin the buoyancy of private sector lending

In August 2018, the annual nominal growth rate of the outstanding balance of credit granted by commercial banks to the private sector was 11.2% (6% in real terms). This growth was less than that of the previous month (11.4%) and of the same month in 2017 (13.3%). Nominal annual growth in the main categories of lending to the private sector was as follows: businesses 15.5% (10.1% real), housing 8.9% (3.8% real) and consumer 6.2% (1.2% real). The growth rates referred indicate that the most dynamic lending portfolio in August was that of business loans. The growth rate in each segment of the portfolio was as well reflected in its contribution to total lending growth. For example, lending to businesses contributed 8.5 percentage points (pp) to the total portfolio growth of 11.2%. The contributions to growth from housing loans (1.7 pp) and consumer credit (1.5 pp) were significantly less. In this regard, the high rate of growth in business lending in August, together with its large relative share of total credit (business loans accounted for 57.1% of total lending) explains why this is the main source of private sector credit growth.

The favourable performance of business lending continues to be driven by the substitution of foreign credit with domestic bank borrowing. The modest momentum shown by consumer credit seems to reflect both lower growth in formal employment and slowing recovery in real wages. Lastly, the moderate performance of housing loans might be associated with a certain reluctance on the part of households to take on mortgage loans, given the limited growth in real wages and the fact that house prices are increasing at a higher rate than inflation.

Term deposits were the main driver of traditional bank deposits growth

In August 2018, the nominal annual growth rate in traditional commercial bank deposits (sight + term) was 12.2% (7% in real terms), higher than the previous month's 10% and also above the nominal annual growth rate recorded in August 2017 (9.5%). This performance was driven by a greater momentum in terms of both sight and term deposits. In the case of sight deposits, the nominal annual growth rate was 9.0%, 2.3 pp higher than the previous month's nominal rate. This greater momentum seems to be linked to increased cash build-up by private individuals, which may be for precautionary purposes, and to a need for greater liquidity on the part of other financial intermediaries (OFIs), possibly in order to meet increased demand for their intermediation services.

Meanwhile, term deposits recorded a nominal annual growth rate of 17.4%, 2 pp above the figure for July 2018. In this case, a scenario of higher interest rates attracted corporate and retail resources to this type of instrument. As a result of this performance, sight deposits accounted for 5.6 pp of the 12.2% growth in traditional bank deposits, while term deposits contributed 6.7 pp.

Among the various types of risk that the financial system is currently facing is that of cyber-attacks

In October, Banco de México (Banxico) published its *2018 Financial System Report*, which analyses the performance of this sector and an assessment of the risks to which it is exposed. The *Report* highlights the fact that domestic financial sector institutions were faced with both internal and external risks in the latter part of 2017 and in the first nine months of 2018. The internal risk factors included the uncertainty and volatility associated with the renegotiation of the North American Free Trade Agreement and the electoral process. In this context, financial institutions were able to absorb the 75 bp increase in the monetary policy interest rate and the exchange rate adjustments thanks to their levels of capitalisation and liquidity. The *Report* also notes that bank lending to households continued to grow over the period analysed, but at a slower rate than in the previous year, as consequence of increased uncertainty and higher financing costs. It also points out that domestic lending to companies grew at a faster rate than external lending, suggesting a possible scenario in which businesses that have borrowed externally might return to the domestic market, possibly making it harder for smaller companies to access their sources of credit.

The *Report* points to the following as the main external risks: (i) U.S. interest rates increasing faster than expected, (ii) escalation of protectionist trade measures on an international level despite the dissipation of the uncertainty regarding the new trade agreement with the U.S. and Canada, (iii) significant portfolio adjustments, with capital outflows due to the worsening situation of certain emerging economies and (iv) reduced prospects for the Mexican economy due to the economic cycle and its effect on potential GDP. In addition to these risks, Banxico also highlights the risk of cyber-attacks. The *Report* also states that the stress tests carried out indicate that, in general, the financial system have the financial strength to tackle adverse events, even extreme ones. It also mentions that the adverse scenarios taken into consideration could worsen in the event of interaction among the various kinds of risk taken into account, and that although the system as a whole is solid, some individual institutions could present vulnerabilities.

The national producer price index for the construction sector increased by 8.1% in the third quarter of 2018, but we expect that at year-end 2019 the increase will have slowed to below 5% on an annual basis

At the close of September 2018, the national producer price index (INPP) for the construction sector was up by 8.1% year-on-year.

The sub-index of construction materials, which is the component with the greatest weight, accounting for around 83% of the changes in the index, increased by 8.7% on the previous year. The materials with the greatest price increases under this heading include cement, concrete and reinforcing bars. The sub-index for machinery and equipment rental rose more slowly as the exchange rate stabilised. This is because rental prices for such equipment are mostly in dollars. At the close of the third quarter, this component of the index had increased by only 3.8% on the same date in 2017.

Meanwhile, wages in the construction sector increased by 5.2%, close to the inflation rate, 5% in annual terms at the end of September. We forecast that the rate of increase in the INPP for the construction sector will slow until the second half of 2019, when we expect to see a return to an inflation rate of below 5%. For more detailed information: https://www.bbvaresearch.com/en/publicaciones/mexico-real-estate-outlook-second-half-2018/

1.2. Financial Markets

Markets respond to the incoming administration's policy decisions

October was characterised by a clear negative differentiation of domestic financial assets following the president-elect's decision to cancel the construction of the New Mexico International Airport (NAIM) in Texcoco. While this decision does not in itself represent a significant cost to the overall economy (around 0.9% of GDP), the negative effect on investor confidence and the uncertainty concerning public policy decision-making going forward form the driving force behind recent and future domestic asset price movements.

As has been the case recently, the exchange rate was the first variable to react to the decision. The peso fell by 7.14% during October, with the dollar trading at over 20 pesos at the end of the month. As a result, the Mexican peso became the second most depreciated currency over the month among emerging currencies, much higher than the level recorded by the average movement of such currencies over the month (-0.6%). On the fixed income market, there was significant upward movement of the curve in anticipation of a more restrictive Banxico monetary policy and increased sovereign risk. As a result, the yield to maturity on 10-year bonds stood at 8.74% at the end of October, a level not seen since 2008.

On the equity market too, there was negative differentiation amid greater risk aversion on equity markets in general. Thus while the benchmark for this asset class fell by 8.55% globally in October, Mexico's IPyC stock exchange index lost more than 12%, affected by the fall in share prices of airport groups.

As a result of the decision to cancel the NAIM project, markets withdrew the benefit of the doubt that they had given the new administration following the conciliatory stance adopted after the 1 July election. Looking ahead, market players will continue to pay special attention to discussions on the 2019 economic package, and in particular how the increased expenditure needed to meet campaign promises will be reconciled with macroeconomic stability.

1.3. Regulation

Adjustments to protective measures regarding credit and debit cards

On 3 October, Banco de México issued Circulars 13/2018 and 14/2018 . They amend existing circulars concerning the protection of credit and debit cards (34/2010 and 3/2012 respectively). The aim of these regulations is to increase transaction security, encourage the use of new technologies, which increase system efficiency and security, establish minimum protection criteria for card users and prohibit unjustified differential treatment based on type of card.

Leverage Ratio Adjustments

In line with the provisions laid down by the Basel Committee, on 5 October the CNBV (National Banking and Securities Commission) amended its Single Banking Circular in order to revise the definition of the leverage ratio and to indicate that it will be considered contrary to sound banking practices for this ratio to be below 3%. The regulation also establishes that details of this ratio must be disclosed to the public.

Adjustments to the regulations regarding payroll accounts

On 29 October, Banco de México published Circular 15/2018 (amending Circular 3/2012) regarding the use of salaries in support of financial services contracted by workers. This reform aims to ensure that employees can use their salary deposits as a source of repayment of loans contracted with any bank on the same terms as those of the bank that administers the payroll account. The regulation seeks to cover the risk associated with the movement of salary accounts to other banks after a loan has been granted. It also seeks to facilitate the procedures required to allow employees to make such movements.