Banking

The Health Emergency Will Deepen the Slowdown in Bank Credit and Deposits

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The COVID-19 pandemic has come at a time of clear slowdown in bank credit and deposits. As a result of a 2019 characterized by economic stagnation, banking intermediation activity in February continued the trend toward slowdown that had already been visible for several months. The balance of the existing credit portfolio granted by commercial banking to the non-financial private sector grew at a nominal rate of 5.4% (1.7% real). This nominal growth was practically the same as that observed in January (5.3%) and significantly below the performance seen in the previous two years (10% in Feb-19 and 12.3% in Feb-18). Meanwhile, during the second month of the year, the nominal annual growth rate of traditional deposits (sight + term deposits) increased marginally by 0.4% on the previous month, reaching 5.9% (2.1% real). However, this growth remained significantly below the nominal rate of 7.6% observed in February 2019 or the annual nominal rate of 10.4% recorded in February 2018.

In the short term, businesses and households' needs for liquidity to cope with the initial negative effects of the health emergency will be reflected in the increased use of credit lines that they already have with banks. However, the prospect of economic downturn resulting from the pandemic means that it is foreseeable that the slowdown in deposits and lending will be exacerbated to such an extent that both items could record negative growth rates during 2020. This is a result of the expected reduction in the income of households and businesses. This reduction, in turn, will directly decrease the ability of households and businesses to pay their bills and save money, while also resulting in a perceived less favorable environment for investment and consumption, leading to greater caution in credit and saving decisions.

The slowdown in business loans continues, with bleak prospects of recovery

In February 2020, the nominal annual growth rate in bank credit to companies was 4.1% (0.4% real). This growth was marginally higher than in the preceding month (3.8%) and was significantly below the result recorded in February 2018 and 2019 (15.6 and 11.8%, respectively). On average, business loans account for 57% of the total balance of credit to the non-financial private sector, meaning that the performance of this segment largely shapes the trend observed in total lending.

The demand for bank credit to companies is associated with the rate of growth in economic activity, as the increase in income resulting from economic expansion helps new profitable investment projects to emerge. The reduced availability of profitable projects, coupled with the uncertainty when it comes to implementing them, is one of the reasons for the lower demand for lending.

With the February figure, business loans have now seen five months with a nominal annual growth rate of less than 5.0%, a level not recorded since July 2010. The pattern in economic activity, gross fixed investment and business confidence in the past six months shows that the macroeconomic environment was suitable for bank credit to companies to grow at higher rates. With regard to economic activity, in the last six months, the IGAE (*Indicador Global de la Actividad Económica* — Global Economic Activity Indicator) has shown average annual variation of -0.7%. This fall is partly due to the severe reduction in investment (the average annual variation in the gross fixed investment index was -5.8% in the last half). The outlook for the business sector has continued to deteriorate, as shown by business confidence indicators, which have contracted at annual rates since the second half of 2019. Thus, in the construction sector, the confidence indicator has fallen by an average of 4.9% in the last six months; meanwhile, it has fallen by 7.5% in manufacturing, 7.9% in trade and 8.9% in services. Additionally, we are likely to see further deterioration in the incentives to invest as a result of the negative signals associated with the cancelation of the Constellation Brands brewery, based on a referendum that was not organized by the electoral institutes as stipulated by law, and in which only 3% of the population participated.

In the short term, we may see an upturn in the nominal growth rate of bank credit to companies — due, on the one hand, to the use of credit lines to meet immediate liquidity needs and, on the other, to the exchange rate valuation effect, which would increase the balance in pesos of loans taken out in foreign currency. However, the expected decline in economic activity arising from the COVID-19 pandemic means that the scenario for the performance of business loans is far from encouraging. The reduction in corporate income, coupled with the absence of a large-scale counter-cyclical program to shore up their recovery, increases the likelihood of companies that were financially viable before the pandemic suffering insolvency problems. Thus, while the need for lending could increase, a number of companies may find their ability to meet financial commitments in a timely manner seriously compromised, calling for greater caution in assessing potential borrowers' ability to pay.

Weakness in private consumption and employment prolong the slowdown in consumer loans

In February 2020, the nominal annual growth rate of the consumer loan portfolio balance was 4.8% (1.1% real). This growth was slightly lower than in the previous month (4.9%) and the nominal growth rates observed in Feb-18 (8.2%) and Feb-19 (6.1%). With this result, the downward trend in consumer loans continues, accumulating 32 months of single-digit nominal growth. In February 2020, the growth seen in credit cards was enough to compensate for the slowdown in the other segments. Thus, credit cards saw nominal growth of 5.2% (vs. 5.0% recorded in the previous month) while auto loans reached a rate of 7.9% in February (vs. 8.2% in January), payroll credit reached a rate of 7.4% (vs. 7.2% the previous month), while the slowdown in personal loans grew more pronounced (contracting by 2.8% vs. 2.4% in January).

This lackluster activity in consumer loans reflects the slowdown in economic activity and, in particular, in private consumption. The private consumption indicator showed average growth of 0.8% between Feb-19 and Jan-20 (latest available information), less than half the average observed the previous year (2.3%). Another factor that has influenced the performance of this type of credit is the reduced growth in formal employment. In particular, the number of workers registered with the IMSS (*Instituto Mexicano del Seguro Social* — Mexican Social Security Institute) rose by 1.5% in February 2020, meaning that the slowdown first recorded for the indicator in June 2018 has now been ongoing for 21 months.

Fewer formal workers means fewer potential borrowers to whom to offer payroll loans or other types of loan for which it is a requirement that customers be in formal employment or have a steady source of income to qualify as borrowers.

Thus, a scenario in which formal employment continues to slow down, and even contract, would not favor the revival of consumption and the demand for credit to fund it.

As is the case with business loans, consumer loans could see a temporary upturn in the short term, associated with the arrival of the COVID-19 pandemic in the country. This increase would be associated with a temporary demand for credit to fund the consumption of staple goods, mainly through credit cards. However, this momentum would quickly converge at growth rates below those observed prior to the health emergency—and could even shrink rapidly—unless economic activity is quickly reinstated and the number of formal jobs is maintained and gradually increased, thereby enabling families to preserve their income and protect their purchasing power. This scenario seems unlikely as there is no determined counter-cyclical fiscal policy; thus, we are likely to see sharp declines in formal employment and consumption. In particular, about 900,000 formal jobs are expected to be lost. Meanwhile, according to the BBVA consumption indicator, falls of around 20% could be observed—prompting falls in the consumer portfolio that have the potential to be higher than those observed in 2009.

Mortgage loans continue to grow at double-digit rates, but are expected to run out of steam

In February 2020, the annual nominal growth rate of the balance of the current mortgage loan portfolio granted by commercial banks was 10.5% (6.5% in real terms). This growth was similar to that of the previous month (10.4%) and less than that observed in the same month in 2019 (9.9%). The momentum observed in the number of IMSS-affiliated permanent jobs in previous years (between mid-2016 and mid-2018, growth rates of about 4% were observed) had a positive impact on the performance of mortgage loans, with a lag effect. This factor, coupled with the relative stability of interest rates for this type of credit, made it possible to maintain double-digit rates over twelve months.

The positive impact of permanent formal employment on mortgage loans is mainly due to the fact that these workers have a stable job and the source of their income can be verified. Furthermore, it makes it possible to check that the borrowers have been employed for a certain period of time. Potential borrowers are less likely to fail to meet their payments if they have a stable source of income and a longer record of employment — particularly in the case of longer-term loans, such as mortgage loans.

The gradual slowdown that began to be observed in the growth of formal permanent employment as of June 2018 was expected to show up in the dynamics of mortgage loans by mid-2020. However, recent lockdown measures and job losses due to the health emergency could accelerate the loss of dynamism in this lending portfolio. The widespread contraction in economic activity due to the COVID-19 pandemic, coupled with gradual deterioration of employment indicators in the following months, could be compounded and their negative impact on the performance of mortgage loans could be extended over time. This is not only because of the reduction in the number of potential borrowers, but also because of the lower payment capacity households would have in the event of a reduction in household income. The sharp decline and slow recovery in formal employment mean that a modest or even zero growth scenario for mortgage loans might be expected in the medium term. Furthermore, given that employment and income variables have a delayed effect on this portfolio, it is expected that growth rates similar to those observed in 2019 (double-digit) could be observed until 2025.

Weak deposits mean vulnerability to the pandemic

During the month of February, growth in banking deposits remained weak, continuing the trend seen since the second half of 2019. While the most significant effects of the COVID-19 pandemic on the Mexican economy will begin to be reflected in March, in February some components of deposits already showed a slowdown that could be a sign of things to come in the coming months. Indeed, during the second month of the year, customers began to shuffle their bank saving instruments in favor of more liquid alternatives. In particular, sight deposits recorded a nominal growth rate higher than the previous month (7.1 vs. 6.3%), while term deposits and debt investment funds (DIFs) moved in the opposite direction, losing momentum compared to January 2020 (4.4 to 4.0% and 10.4 to 9.1%, respectively).

Given the reduction in the monetary policy interest rate since August 2019, term savings of individuals and companies alike registered negative growth at an annual rate in real terms. However, the growth in total term deposits was positive, given the significant increase in funds accumulated by the Non-Financial Public Sector (NFPS), which in 2019 recorded an average annual growth rate of 92.1% in real terms (98.8% nominal). Thanks to this momentum, this type of deposit doubled its share (from 1.8% in Dec-18 to 3.7% in Dec-19). In February, this growth rate fell to 41.0% (46.2% nominal), its lowest level since last March. This reduction in February could be associated with a decrease in public underspending compared to 2019. However, the most important issue is that, given the health sector's extraordinary demands for resources to deal with the pandemic, the resources accumulated by the NFPS could be used in the coming months, in which case the annual growth rate in its term deposits will fall continuously. In this scenario, the relevant contribution that these deposits made to total term deposits would quickly fade.

The other components of term deposits maintained the weakness seen in recent months due to lower interest rates. Annual growth rates in nominal terms of term deposits of individuals and companies (75% of total term deposits) were 0.9% and 0.2% (-2.7 and -3.4% real), respectively. Thus, for the last seven months, they have grown below a nominal rate of 5.0%, with negative real growth rates for six months running. Looking ahead, the fall in term deposits in these segments is expected to worsen, not only because of Banxico's cycle of monetary easing, but because the economic downturn on the horizon will prevent funds from being put aside for medium-term savings. It is worth remembering that, back in 2009, the 5.0% downturn and the reduction of 375 basis points in the monetary policy rate led to a reduction of about 27 percentage points on average in real growth in term deposits by individuals and companies. As such, it is highly likely that total term deposits (40% of traditional deposits), the annual nominal growth rate of which reached 4.0% in February (0.3% real), will reach zero nominal growth and even turn negative in real terms for the first time since November 2014.

The second component of deposits in the banking system that showed significant slowdown during the second month of the year was that of DIFs. Toward the last third of February, as the number of cases of COVID-19 in Italy increased, so did the volatility of the financial markets. As a result, the exchange rate depreciated by 4.2% in the month, while government debt interest rates began to record an uptick of about 20 basis points during the month in question. The trend in DIFs has proven to be sensitive to the volatility of financial markets, particularly exchange rate volatility. Therefore this is considered to be the main factor behind the slowdown in the annual nominal growth rate to levels of 9.1% (5.2% real) in February, leaving behind the double-digit growth observed between May-19 and Jan-20. It should be noted that this rate in real terms is the lowest since April 2019. The fact that the volatility of the financial markets reached its highest point in March suggests that the slowdown in the growth of DIFs could continue.

Lastly, the sight deposit component (60% of traditional deposits) showed marginal changes in February. Nominal annual growth in sight deposits by individuals remained in double digits (13.5% nominal). However, their annual growth fell slightly in real terms, from 9.9% in January to 9.5% in February. The substitution effect from term deposits could have contributed to this growth, however, given the looming loss of formal jobs due to the lockdown measures and the economic downturn itself, this type of deposit would be expected to show significant slowdown from March. Corporate deposits registered an annual nominal growth rate of -0.9% (-4.4% real), marking a run of 11 consecutive months with negative annual nominal growth rates (a period that becomes 18 months if growth rates in real terms are considered). This behavior has been influenced by the protracted fall in private investment (Gross Fixed Capital Formation), which in December registered a real annual growth of -3.7%, the sixteenth negative growth rate in the last 17 months. Looking ahead, given the suspension of activities due to the lockdown and the limited support from the federal government, companies are likely to significantly increase their use of these resources to try to cover their fixed costs.

In short, February confirmed the lack of dynamism in the deposits growth of the banking system. Because of this weakness, deposits are in a vulnerable position when faced with the adverse effects that the COVID-19 pandemic will have on the economy and the financial markets.