Banking

Monthly Report on Banking and the Financial System

Fernando Balbuena / Alfonso Gurza / V. Gabriela López / Iván Martínez Urquijo / Carlos Serrano / Mariana A. Torán / Samuel Vázquez
May 29, 2020

1. Banking and the Financial System

Effect of the exchange rate boosts the dynamism of bank credit to the private sector

In March 2020, the outstanding balance of credit granted by commercial banks to the private sector grew at a nominal annual rate of 10.5% (7.0% real), almost 5.0 percentage points (pp) above the rate seen in the previous month (5.4%) but below the nominal rate for March 2019 (11.1%). This result was mainly due to the significant rebound in business loans, which even showed a double-digit growth rate. By contrast, consumer loans continued the slowdown that had been observed in previous months, while dynamism decreased for mortgage loans, whose nominal growth rates fell below double-digits. Based on this performance, the contribution made by the components of total bank credit to this growth of 10.5 percentage points (pp) was as follows: business loans contributed 7.9 pp; mortgage loans, 1.8 pp; and consumer loans, 0.7 pp.

The observed rebound in business loans, whose momentum improved the dynamism observed in total credit, originated mainly from an accounting effect associated with the valuation of balances denominated in foreign currency and, to a lesser extent, the use of companies' credit lines to meet their short-term liquidity needs. In the future, this accounting effect may continue to be observed; however, the structural factors driving companies' credit demand continue to deteriorate, as shown by the contraction of the gross capital formation indicator. The outlook is also not encouraging in the case of consumer and mortgage loans, as the loss of job creation dynamism in recent months adds to the negative impact expected from measures to alleviate the COVID-19 pandemic. Similarly, a decline in household income will also drag growth rates in lending to families down from those recently observed, with the possibility that these rates may become negative in the face of high job loss expectations in the coming months.

Bank deposits show a rebalance toward liquid instruments

In March 2020, the nominal annual growth rate of traditional bank deposits (demand + term) was 13.9% (10.9% real), showing an unusual increase from the result observed in February (when it registered a nominal growth of 5.8%) and in March 2019 (when it grew 7.7%). In fact, both the increases in the monthly rate (8.2%) and the annual rate (6.7%) in March in real terms of traditional deposits stand as new record highs. This unusual increase is likely a response to the liquidity needs of companies and families to face both the confinement phase and the suspension of non-essential business resulting from emergency measures related to COVID-19. This rebound appears in even greater contrast still when we consider the fact that bank deposits have slowed significantly since last August, to such an extent that these reached a historic low growth of 4.4% at the nominal annual rate in October 2019. In terms of components, of note are the change in trends both in companies' term and demand deposits, and the strengthening of demand deposits of natural persons, which resulted in a greater contribution to growth. In particular, demand deposits contributed 9.8 percentage points (pp) to the 13.9% growth in traditional deposits, while term deposits contributed 4.1 pp. Meanwhile, Debt Investment Funds (FIDs) reduced their dynamism, reflecting the negative impact of increased uncertainty and the preference of agents toward more liquid savings alternatives.

Moving forward, even though an environment of lower interest rates and greater need to maintain liquid balances to meet first-need expenditures both point to an increase in demand deposit holdings by economic agents, this momentum could be offset by the expected decline in household income as a result of the COVID-19 pandemic's negative impact on economic activity and employment. On the other hand, the reduction in interest rates, coupled with spending needs and the expected decline in sources of income, will offer little room for agents to retain term resources, thus this segment is expected to show little dynamism in the future. A decrease in term deposit balances may even be seen as agents find themselves needing to use their savings to finance current expenditures.

Commercial banking leads intermediation of deposits and credit to the private sector

The National Banking and Securities Commission (CNBV) published the update of the report on Financial Savings and Financing in Mexico with information as of December 2019. The document highlights that total financial savings showed real annual growth of 4.0% and represented 94.0% of GDP in Q4 2019 (vs 89.4% registered in Q4 2018). In terms of components, in the reference period, domestic financial savings saw real annual growth of 5.6% (representing 67.2% of GDP), while external savings showed real annual change of 0.2% (representing 26.9% of GDP). Within domestic savings, most of the saved resources are concentrated within commercial banking institutions (21.0% of GDP), followed by Infonavit (4.9% of GDP) and development banking (3.6% of GDP).

Total financing (to both the private and public sectors) showed a real annual growth rate of 1.8%, equivalent to 95.4% of GDP in Q4 2019. Domestic financing grew at a real annual rate of 3.1%, representing 78.1% of GDP, while external financing fell to an annual rate of -3.9%, representing 17.2% of GDP at the end of 2019. The main source of private-sector domestic funding in the reference period was credit granted by commercial banks (18.8% of GDP), followed by credit from other financial intermediaries (regulated, unregulated and development agencies), which reached 11.4% of GDP.

In the first quarter of 2020, the percentage of companies that received bank credit increased

The Bank of Mexico published an update of its Quarterly Credit Market Assessment for Q1 2020. With regard to the sources of financing used by the companies in the reference period, 36.5% of companies surveyed stated that they used commercial banking financing, a higher percentage than in the previous quarter (34.1%) and in the same quarter of the previous year (32.2%). This increase seems to offset the lower use of other sources of financing, given that a decrease in the percentage of companies that used credit from suppliers, from banking abroad, from companies of the same corporate group, and through debt issuance was highlighted compared to Q4 2019.

In particular, with regard to corporate indebtedness to banks, 47.6% of companies indicated that they had bank credit at the beginning of Q1 2020. 24.2% of companies used new bank credit in the first quarter of the year, slightly lower than in the previous quarter (25.1%) but higher than in the same quarter of 2019 (21.4%).

With regard to the cost of financing, companies that used new bank credit expressed having faced more favorable conditions than the previous quarter in terms of interest rates. However, this improvement does not seem to have extended to other access conditions of bank credit, as these companies perceived less favorable conditions compared to Q4 2019 with regard to the terms and amounts offered, the conditions for refinancing loans, collateral requirements, credit approval times, commissions and other expenses.

Commercial banking has the solvency required to continue granting credit and overcome possible losses

The Bank of Mexico presented its Quarterly Report, which included an analysis of the financial system's stability. The report highlights the fact that banks show high levels of solvency, giving them room to maintain credit and overcome losses. The Capitalization Index (ICAP) for commercial banks increased to 16.27% in February, up from 15.98% in December. By incorporating possible extreme unanticipated credit losses (measured by CVaR at 99.9% confidence), the ICAP for commercial banking stood at 10.73% in February, placing it even above the regulatory minimum, including reserves, of 10.5%. It should be noted that all these scenarios are based on historical information.

As for market risk, there was an increase in Q1 2020. The expected value of the loss in the distribution's tail (CVaR at 99.9% confidence) rose from 4.62% in December 2019 to 6.22% of net capital in March as a result of the increased volatility of risk factors (i.e. interest rates, exchange rate) in the face of the longer duration of banking portfolios. The reduction in risk aversion in recent weeks makes it possible to expect that this level of risk will decrease.

The document highlights that the reduction in oil prices significantly pressured PEMEX's financial position. Faced with higher liquidity risks and high debt levels, the three main rating agencies reduced the oil company's rating in March and April. With this, it is positioned as a speculative grade for both FITCH and Moody's. As a result, the cost of credit protection for its debt (CDS) was increased above companies with similar or worse ratings. In recent weeks, this cost of coverage has fallen, albeit at a slower pace than other comparable oil companies.

Private companies, for their part, showed greater leverage and lower debt-servicing capacity during the first quarter of the year in the face of exchange-rate depreciation and the expected drop in demand. However, the greatest impact is expected to be observed in the second quarter of the year. On this subject, a section in the Report finds that a reduction in the monetary policy rate results in a lower bank interest burden, although the extent of this depends on the size of the company. According to the results presented, for each percentage point of reduction in the target rate, the financial burden of companies would be reduced by 3.7% for large companies with issued debt, 3.5% for large companies (bank credit of more than MXN 100 million), and 2.2% for small companies. Within the latter group, the reduction in the financial burden is only 1.2% for companies with a maximum credit balance of MXN 10 million.

The mortgage burden on households in Mexico remains stable

In 2018, average quarterly current income fell by 4.1%. This is explained by the declines in the three highest income deciles, which were the most affected. Despite the decline in household income, the financial burden of mortgage payments remained relatively stable at almost all income deciles. In terms of international risk measurements, it is commonly held that a family should not spend more than one-third of its income on mortgage payment. In Mexico, only 20% of lower-income households that report having a mortgage loan have a financial burden of more than 30% with regard to this type of loan, while the rest have a ratio of 21% or less. For this reason, it is considered that on average, 80% of households do not experience significant pressure in paying their mortgage with regard to their income. This is due to the continuous improvement shown by the banking origination criteria which, among other things, ensure an adequate payment ratio as a percentage of income.

Given the economic crisis that is emerging from pandemic-related measures, a deterioration in the quality of the housing portfolio and an increase in the mortgage burden for households that see a reduction in their income is to be expected. Workers at the highest risk of a decline in income are those in the informal sector. Deciles I and II, which are the lowest income, account for more than 50% of informal workers.

To view the full study, please click on the following link: https://www.bbvaresearch.com/en/publicaciones/mexico-real-estate-outlook-first-half-2020/

2. Financial Markets

Risk asset price recovery in the face of lower global volatility. The Mexican peso was the most appreciated currency in May

The reopening of a large part of the economies of developed countries, following a lower spread of COVID in May, has strengthened the prevailing narrative in financial markets according to which the worst is behind us, and the recovery of the global economy will take place beginning in the third quarter. This narrative, based on extraordinary fiscal and monetary support measures, has been reflected in lower volatility across various asset classes and in price recovery, particularly those of risk assets.

Undeniably, the exchange rate recovery was the most significant movement among domestic assets in May. Between April 30 and May 29, the Mexican peso appreciated 7.7%, making it the most appreciated currency among emerging currencies during this period. The benchmark for this group of currencies appreciated by 2.8% during said period. The exchange rate already trades below 22.3 pesos per dollar and has been supported, in addition to the lower overall risk aversion (the VIX® index is already below 30% at the end of May), by a lower general demand for dollars and higher oil prices. In fact, Mexican mixed crude oil closed at around 28 dollars per barrel in May after hovering around 12 dollars at the end of April. This represents a gain of more than 100%, well above both the increase in the Brent crude price (39.6%) and the global commodity index benchmark (16.5%, GSCI) for the same period. Even with the peso's significant appreciation in May, the Mexican currency is the third most depreciated so far this year (17.9%), only behind South Africa (20.2%) and Brazil (24.35%).

In the fixed income market, lower yields in the government curve were observed. The yield to maturity (YTM) of the Mbono 10-year bond fell 45 bp between April 30 and May 29 and stands at around 6.2%. This reduction was influenced, first, by a lower sovereign risk, measured by the 5-year CDS spread, which fell 75 bp to 180 bp at the end of May. However, despite this significant reduction, Mexico continues to be listed among countries with BBB- ratings. The lower YTM of the Mbono 10-year bond was also influenced by the expectation of further cuts in the monetary policy rate by the market (around an additional 100 points by the end of 2020). The lower YTMs of the government curve and exchange rate appreciation, in an environment of lower risk aversion, gave rise to a slower rate of outflows by foreigners. In fact, during the first two weeks of May, these investors reduced their holdings by USD 156 million, which is clearly lower than the first 15 days of March (around USD 2.880 billion) and April (around USD 1.560 billion). Despite this, between March 1 and May 14, foreign holdings in Mbono bonds have fallen by USD 11.760 billion, a figure that exceeds what was observed in percentage terms for the period between October–December 2008.

It is important to note that, while the peso has seen a significant recovery, liquidity levels in the exchange market (as measured by the bid-ask spread) are clearly lower than their historical level and short-term volatility remains high (around 20% for implied volatility at one month). These indicators are particularly relevant for hedging costs, and thus, for a partial recovery of foreign holdings of government bonds.

While stock market earnings were more moderate than in April, increased demand for stocks of businesses tied to the economic cycle began to appear, and not just for securities of companies with high growth expectations, such as those in the technology sector. In fact, between April 30 and May 28, the Russell 2000 Index, which groups small and medium-sized businesses in the US, grew by 6.4%, greater than the 4.0% of the S&P500. During this period, the US market was below the overall benchmark performance for this class of assets (MSCI World), which increased by 4.65%. This behavior may be influenced by a further increase in trade tensions between the US and China toward the end of May. For their part, the stock markets in emerging countries, grouped together in the MSCI EM, did not show growth in May, which may reflect the fact that the greatest impacts on productive capacity from the pandemic will be concentrated in several of these countries. In line with this behavior in emerging countries, the IPC index barely saw an increase of 0.1% between April 30 and May 28.

Bottom line, market participants seem to consider the shock of the pandemic to be similar to that of a natural disaster, sticking to the narrative that the worst is behind us and that fiscal, and, above all, monetary measures, will be enough to restart growth at the global level. This expectation is subject to risks of all kinds, not only those related to the pandemic itself (e.g. the possibility of a second wave of infections), but also to consumer behavior (e.g. changes in preferences after the pandemic). The coming months will allow us to assess the robustness of the assumptions in the current narrative and, in any case, we will see changes in investment decisions as the global economy enters in unchartered territory.

3. Regulation

Banxico issues regulations stemming from measures announced on April 21

In order to implement the second package of measures announced on April 21 and aimed at providing liquidity and promoting the orderly functioning of the markets, between May 8 and 19, Banco de México issued a series of adjustments to its regulation concerning cash operations and correspondents (14/2020); financing to cover ordinary additional liquidity needs (15/2020); temporary facilities for securities lending (16/2020); as well as reporting of government securities (17/2020) and corporate securities (18/2020) to be carried out with Banco de México to meet liquidity needs.

Similarly, on May 25, it issued several provisions, which are still pending publication in the Official Journal (*Diario Oficial*): amendments to the Repo Circular (19/2020); on the provision of resources to credit institutions to deliver credit to MSMEs (20/2020); administrative provisions on the suspension of term dates, and sanctions and inspection processes (21/2020); and those enabling entities to refrain from making minimum charges to their borrowers as a measure of support during the ongoing crisis (22/2020).