BBVA Research

Banking

# Monthly Report on Banking and the Financial System

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## 1. Banking and the Financial System

### Bank credit continues to slow down with unfavorable prospects for recovery

In February 2020, the balance of the existing credit portfolio granted by commercial banking to the non-financial private sector (NFPS) grew at a nominal rate of 5.4% (1.7% real). This nominal growth was essentially the same as that observed in January (5.3%) and significantly below the 10% rate observed in February 2019.

On average, business loans account for 57% of the total balance of credit to the NFPS, meaning that the performance of this segment largely shapes the trend observed in total lending. 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 fall in economic activity associated with the pandemic and the resulting reduction in companies' revenues could reduce both the ability to meet their financial commitments in time and form, and the willingness to take out new loans. This would be reflected in an even greater slowdown in this portfolio.

As is the case with business loans, consumer loans could see a temporary upturn in the short term, associated with the initial effects 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. 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. In addition, the overall contraction of economic activity, accompanied by the gradual deterioration of employment indicators in the following months, could aggravate and prolong the negative effects of household income loss on mortgage loan performance in the medium term.

### Weak deposits mean vulnerability to the pandemic

During 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. 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.

For their part, the behavior of DIFs has been sensitive to financial market volatility, especially exchange rate volatility. This is therefore considered to be the main factor behind the slowdown in the annual growth rate in nominal terms at below double-digit levels. 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.

## Mexico's *Consejo de Estabilidad del Sistema Financiero* (Council for Stability of the Financial System— CESF) updated the risks of the financial system as a result of the COVID-19 pandemic

The CESF announced the main points addressed in its meeting held on March 31 to update its risk assessment. The expected macroeconomic shock from the COVID-19 pandemic generated significant downward revisions in economic growth and increased risk aversion, which was reflected in portfolio adjustments and increased volatility. In this environment, the sharp decreases in oil prices resulted in adjustments in exchange rates, interest rates, and risk premiums.

In this context, the Mexican financial system faces the following challenges: maintaining an adequate flow of financing for the various economic agents, maintaining appropriate liquidity conditions in domestic and foreign currency, supporting adequate operating conditions in the currency and bond markets, facilitating intermediaries in managing their market and credit risks, and ensuring the proper functioning of payment systems.

In order to meet these challenges, the CESF highlighted some of the measures taken by the authorities as at the date of the statement: a reduction in the monetary regulation deposits for commercial and development banking to promote the credit offering, a reduction in the cost of the ordinary liquidity facility, a credit auction, and an increase in the foreign exchange hedging and government security swap program to improve the operation of the bond market.

## In the first two months of 2020, mortgage origination fell by 1.9%

As at February 2020, the cumulative origination of mortgage loans by commercial banks decreased by 1.9% in the amount of financing in real terms compared with the same period in 2019. This contraction in private sector mortgage activity reflects deterioration in consumer confidence in December, when the overall index fell by 2.5% in annual terms compared to the close of the previous year; while the confidence in housing (purchase, renovation, or extension) decreased by 11.5% over the same period.

As we have already mentioned on previous occasions, confidence for the purchase of a home is closely linked with formal employment, which continued to grow in 2019 but at increasingly lower rates. In December 2019, according to data from the IMSS (*Instituto Mexicano del Seguro Social* — Mexican Social Security Institute), the number of formal workers increased by just 1.7%, while the previous year had recorded an increase of 3.4%. It is important to emphasize that employment and confidence have a lagging effect on demand for mortgage loans, in addition to the effect of the crisis caused by the COVID-19 pandemic. We hope that the data for March and April will more strongly reflect this event, for which demand will remain negative for the rest of the year.

# 2. Financial Markets

## Domestic asset prices differ negatively in an environment characterized by a clear contrast between the significant recovery of stock markets and fundamentals

The Coronavirus pandemic has again highlighted the contrast between the expectations on the outlook of economic activity that can be taken from the prices of various financial assets. On the one hand, in April, stock markets not only stopped the fall, but also recorded a significant recovery that represented a 10.8% increase in the global benchmark of this asset class (MSCI World Index) and 9.0% for emerging markets benchmark (MSCI EM Index). In the US, the current center of the pandemic, the S&P500 increased by 12.7%, its greatest monthly increase since 1987. This was even after the annualized 4.8% drop in US GDP in the first quarter and the number of jobless claims reaching 30 million in the last six weeks.

This behavior of the stock markets seems to be based on three factors. First, the substantial increase in liquidity generated by unconventional monetary policy measures by major central banks, which amounts to around USD 5 trillion. Second, the perception that the pandemic has peaked and that, in the coming weeks, the reduction in infections will enable economic activities to resume. Third, the expectation that there will be a significant and continuous recovery in global economic activity as of the third quarter of this year, supported, in turn, by the idea that fiscal support (i.e., USD 2 trillion in the US) will be sufficient for companies' liquidity problems resulting from lockdown measures to not turn into solvency problems going forward.

On the other hand, fixed income and commodity markets seem to incorporate different expectations that are more in line with economic data. The yield to maturity of the 10-year US Treasury bond closed in April at 0.64%, such level discounts the fact that the federal funds rate will remain at its current levels of between 0.0 and 0.25% for a long period of time given the effects of the economic downturn on aggregate demand. It should be recalled that the yield to maturity of the two-year bond closed in April at 0.19%, a six-basis point (bp) drop from its level in March. As regards commodities, this asset class benchmark (S&P GSCI) rose marginally by 0.6% during April. However, this is the indicator's lowest recorded level since 2003, after a 41.1% fall so far this year. The latter in view of the collapse in demand that will be reflected by excess supply globally due to the lockdown measures arising from the pandemic. Within this asset class, the oil market is a true reflection of these expectations. In a market with excess supply and limited storage capacity, on April 20, one day before the expiration of the futures contract, the price of the WTI oil barrel for delivery in May was listed as negative for the first time in history. While this phenomenon was more of a market event, it exposes the extent of the expected drop in demand and the level of excess supply, even after the OPEC+ agreement to cut production.

In this context, in April, Mexican asset prices differed negatively from those of other emerging countries (EM), affected by insufficient government support measures to mitigate the economic effects of the pandemic and by the increased vulnerability of public finances given the continuing deterioration of PEMEX's financial situation. In fact, in response to the expected increase in credit risk, both the sovereign debt rating and the foreign currency rating of the Mexican oil company were cut in April. With this, Mexico has a BBB rating, one step above the rating required to be considered investment grade, while the PEMEX debt is already considered speculative by two rating agencies.

For most of April, the exchange rate remained above 24 pesos per dollar, representing a 2.1% depreciation during that month. This depreciation ranked the Mexican Peso as the fifth most depreciated emerging currency in April and contrasts with the 0.8% appreciation of the JP Morgan EM Currency Index benchmark. Between December 31, 2019 and April 30, 2020, the peso ranks as the third most depreciated currency among EM currencies, after a 21.5% slump. It should be noted that, at the end of April, liquidity conditions in the foreign exchange market improved. However, indicators such as the bid-ask spread remain high, such as those observed during the US presidential election in 2016. Similarly, sovereign risk, measured by the 5-year CDS spread, increased by 14.7 bp in April, the fourth largest increase among EM countries, closing at 255 bp. However, during the last part of the fourth month of the year, it exceeded 300 bp, for the first time since 2009. These levels place Mexico's sovereign risk in the upper part of the group of countries with a BBB- rating, such as Colombia and Russia. It is worth noting that, while Mexico did not consistently price above these two countries in the past, it has been trading within this BBB-rated group for some time before recent rating agencies actions.

The combination of a higher sovereign risk and a significant increase in exchange rate volatility (25.8% on average at the one-yearmaturiry in April) have made Mexico's government debt bonds less attractive. In fact, between March 1 and April 13, the ownership of CETES (Mexican Federal Treasury Certificates) held by foreigners fell by around USD 890 million, while that of M-bonds fell by around USD 8.780 billion. However, this fall is still slightly lower in percentage terms than the fall observed in October and November 2008. In terms of long-term interest rates, this selloff by foreigners and the increase in sovereign risk has been offset by expectations of a reduction in the monetary policy rate (TPM). Indeed, the TIIE (*Tasa de Interés Interbancaria de Equilibrio* — Mexican Equilibrium Interbank Interest Rate) swap (IRS) curve currently discounts just over 150 bp of additional cuts for the TPM this year, in addition to the 100 bp this rate has been cut by since March. Additionally, it should be noted that the IRS curve discounts the fact that rates will remain low for a long time. Thus, these expectations for the TPM impacted the yield to maturity of the 10-year M-bond, which fell by 50 bp in April and closed at 6.6%.

As regards PEMEX bonds, it is expected that over the coming weeks several investment funds will complete the sale of their positions as a result of the loss of investment grade in April. However, given the explicit support of the federal government, some market participants have indicated that there could be interest in PEMEX issues, given the high disparity between the performance of the oil company's issues and those of the country (700 bp on average at the 10-year maturity in April). Financial market participants' repeated expectations of unreserved government support to PEMEX further complicates the scenario for public finances and, consequently, for the country's sovereign debt rating. This, given the oil company’s rising losses and high production costs that will make it harder to service its debt, most of which is in foreign currency.

In short, it will be necessary to remain cautious in the light of the recent rally in stock markets. The gradual opening up of some economies in the coming days will give us an insight of how risky is a second wave of infections and, only then, we could have more elements to judge the assumption that the pandemic has already peaked and the expectation that economic activity will surge during the third quarter of the year. Once this happens, we could see a greater alignment between the price signals of the different asset classes and the economic fundamentals.  With regards to Mexico, it seems unlikely that the negative differentiation of its domestic asset prices will be eliminated, provided that the economic measures of government support to deal with the pandemic are not increased and provided that the government position regarding the role of PEMEX as a priority in the development of the country is maintained.

# 3. Regulation

## Response to the COVID-19 Contingency

On April 1, Banco de México, issued various circulars in order to implement the measures announced on March 20,: i) Circular 3/2020, setting out the rules applicable to US dollar credit auctions, which banks should observe, ii) Circular 4/2020, setting out the rules on financing granted by Banxico to cover additional ordinary liquidity needs, iii) Circular 5/2020, setting out the procedure to be followed by banks and stock exchanges to act as Government Securities Market Makers, iv) Circular 6/2020, setting out the procedure for market-makers to exercise the right to purchase government securities, and v) Circular 7/2020, reducing the total amount of monetary regulation deposits.

Subsequently, on April 9, it issued several circulars on various pandemic-related issues: i) Circular 8/2020 , setting out the interim measures of operations and cash settlements, providing for the suspension of sanctions resulting from failure by banks to deliver suspected false bills, also extending the deadline for them to provide information on cash/valuables in transit companies and limits the operation of cash correspondants with users to two days a week, (ii) Circulars 9/2020, 10/2020 and 11/2020 setting out provisional measures applicable to reporting obligations, and (iii) Circular 12/2020, providing for the suspension of time limits relating to administrative sanction procedures, review resources and information requirements until May 4. It also provides for the suspension of inspection visits until April 30.

In the same vein, on April 17, it issued Circular 13/2020, providing for temporary exceptions to the minimum payment rules for credit cards, allowing financial institutions not to charge such payments between April and June 2020.

Lastly, on April 21, it announced a second package of measures to promote an orderly behavior of financial markets, to provide liquidity and specific actions to strengthen credit-granting channels. Specifically, it provides for resources to banking institutions to channel credit to MSMEs and people affected by the pandemic.

On April 9, the CNBV issued an amending resolution to extend the entry into force of obligations related to obtaining biometric data from clients. Likewise, on April 17, it issued an agreement extending to April 30 the term of the Agreement published on March 26. Subsequently, on April 28, it issued a new agreement extending the term to May 30.