Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

The liquidation process of Banco Ahorro Famsa begins

On June 30, the CNBV notified Banco Ahorro Famsa of the revocation of its license to operate as a commercial bank. The banking regulator cites inappropriate risk management, operations and credits granted to persons related to the group that are above the regulatory limits and an improper registration thereof as causes of this event, in addition to recurrent non-compliance with various regulatory provisions.

The liquidation of Banco Ahorro Famsa, with assets representing 0.35% of the system's total, is an isolated event that is not a direct consequence of the economic effects of the pandemic and does not jeopardize the functioning of the banking system as a whole. Also, it should be remembered that the existing liquidation mechanisms allow savers' deposits to be reintegrated without using public resources and without creating problems for the rest of the banking system.

Finally, it is worth noting that, given the outlook of an economic downturn resulting from the health emergency, timely publication of economic figures in general and on the performance of banking activity in particular by the authorities is of the utmost importance.

Consumer loans are no longer driving total private sector financing

In April 2020, the nominal annual growth rate of bank credit to the non-financial private sector (NFPS) was 11.2%, higher than the previous month's growth (10.4%) and that of the equivalent month in 2019 (10.3%). The nominal growth of 11.2 percentage points was made up of 3.6 pp from the valuation effect of exchange rates, 2.4 pp attributable to inflation and 5.4 pp corresponding to real growth in balances. Stripping out the valuation effect of exchange rates and inflation, NFPS credit averaged a real growth rate of 3.2% in the first four months of the year, lower than the real rate of 5.5% observed in the first four months of 2019. Notably, business and mortgage loans supported the observed momentum in the first four months of 2020 (contributing 1.9 pp and 1.2 pp, respectively), while the slowdown in consumer loans has been reflected in an almost zero contribution (0.05 pp) to the growth of the total portfolio.

In April 2020, the real annual change in the consumer loan portfolio balance was -1.9% (0.2% nominal), the first drop since Oct-10, when the real change was -1.5%. This result accentuates the slowdown in consumer loans, which have not seen double-digit real growth rates since Sept-16. On average, the real annual growth rate of consumer loans in the first four months of 2020 was just 0.2%, almost one-tenth of the already modest growth observed in the same period of 2019 (1.8%). By segment, the standout is the credit crunch observed in cards and personal loans, which has begun to counteract the momentum still recorded by payroll loans and consumer durable loans (CDL).

Bank deposits reverse the weakness shown since the second half of 2019

In March and April 2020, the nominal annual growth rate of traditional bank deposits (demand + term) was 13.9% and 15.7%, respectively. Even allowing for exchange rate and inflation effects, traditional deposits rebounded significantly from March, when they registered real growth of 6.6%, which accelerated to 8.9% in April, the highest real rate observed since Sept-15, when real growth was at 10%. With the results of these two months, the average real growth of traditional deposits in the first third of the year was 4.7%, higher than the 2.5% rate reported in the same period of the previous year.

As a result of the fall in interest rates, demand deposits have regained importance as a driving force for traditional deposits, and in the first four months of 2020, they contributed 3.9 pp to the average growth of 4.7%, while term deposits contributed just 0.8 pp.

The greater momentum in demand deposits can be explained mainly by three factors. First is the increased accumulation of liquid assets by households and businesses for precautionary reasons due to the uncertainty caused by the COVID-19 pandemic. Some of the demand deposits accumulated by businesses may well have come from lines of credit used in recent months. The second factor is the reduction in consumption exacerbated by lockdown measures in the wake of the COVID-19 pandemic. Lastly, this increased demand for liquidity is taking place along with a cycle of cuts in the monetary policy rate, which reduces the opportunity cost of maintaining liquid assets.

Everything seems to indicate that this unusual increase most likely responds to the liquidity needs of businesses and households in coping with the lockdown and suspension of non-essential activities caused by COVID-19. However, the temporary build-up of these deposits will probably be diluted as households and businesses meet their recurrent spending commitments and income flows are reduced by lower levels of employment and the contraction in economic activity.

The IMF draws attention to the decoupling of financial markets and the fundamentals

In its update of the Global Financial Stability Report, the IMF highlights the reduction in financial tensions that have been observed since the last week of March. But it emphasizes the disconnect between the financial markets' performance and economic fundamentals, as well as the vulnerabilities of public finances and bank balances in the face of the uncertainty posed by the COVID-19 pandemic and the measures to overcome it.

Fiscal support from governments around the world amounting to USD 11 trillion, as well as unconventional monetary measures to maintain the economy's credit flow of USD 6 trillion (G10) have underpinned valuations of risky assets, and, as a consequence, the recent recovery of the equity and credit markets. The market participants' perception that central banks will maintain their unprecedented support measures (the G10 central banks' support measures are estimated to be more than double the measures that were granted during the two years of the 2008 financial crisis) exacerbated by the optimism of a quick economic recovery, following confinement measures, have led to a disconnect between the financial markets' performance and economic fundamentals. This disconnect opens up the possibility of a new asset-price correction that could jeopardize the recovery and even feed back into the economic downturn. In an environment as uncertain as the current one, factors such as a new wave of infections that force the lockdown to continue, doubts about central bank support, or even trade tensions could be catalysts for this correction.

In addition, the pandemic could lead to other accumulated vulnerabilities, such as those arising from high levels of corporate and household debt in the face of an economic downturn. In turn, the higher probability of default will test the resilience of the banking sector.

Banxico emphasizes the robustness of the financial system in the face of the pandemic

The COVID-19 pandemic and the measures associated with its containment have led to risks throughout the economy as a whole. At the same time, we not only witnessed a drop in supply and demand but a significant increase in volatility for virtually all risky assets, which led to increases in risk premiums, outgoing flows from non-residents and a deterioration in financial conditions. In this context, the main message of the Banxico Stability Report is the strength in the capital and liquidity position with which the Mexican financial system faces the pandemic.

The macroeconomic context described was reflected in increased demand for corporate and business loans for commercial banks (48% of the financial system's assets). This increased demand for credit for precautionary reasons and the reduced supply of resources in debt markets led to slight reductions in both regulatory capital, due to the growth of risky assets, and the liquidity of the system. In fact, Banxico notes that at the end of March, commercial banks had sufficient solvency levels (banks' capital ratio of 15.75%) not only to meet the higher demand for credit but also to face unexpected high-loss scenarios like those that were observed in the past. In particular, the credit risk-adjusted banks' capital ratio (Conditional VaR) stood at 10.06% in March, above even the regulatory minimum. While this indicator is proof of the banks' resilience, it is important to note that it is only a guideline, as it is associated with historical loss scenarios and not with the most adverse conditions that could arise with the COVID-19 pandemic.

In terms of liquidity, higher demand for credit and zero activity in the unsecured loans market resulted in a fall in the liquidity coverage ratio (LCR) during March, although during the first quarter the system kept an average of over 100%, which is the regulatory minimum for most banking institutions. It should be noted that, unlike the crisis of 2008, the repo market more than compensated for the drop in financing in the unsecured loans market. Banxico notes that in a stress scenario that assumes that banks are not renewing interbank loans or securities issued, for the period January-April, only 4.4% of the total number of banks in the system (2.6% of total assets) would not be able to meet their obligations solely with their liquid assets for a period of at least 20 days. While considering these indicators and with the aim that the regulation does not hinder the flow of credit required by the financial agents, Banxico and CNBV issued temporary exceptions to the liquidity provisions that will be in force for six months from February 28. In contrast, 68.5% of institutions could meet their obligations for 60 or more days. Finally, it is noted that in foreign currency, the LCR is above 100% for the system. Even at the end of April, this indicator is above the LCR for the total of currencies.

The market risk of commercial banks increased significantly during March in the face of higher volatility and risk premiums in the financial markets. In fact, expected losses in the worst 0.1% of distribution increased to represent 6.22% of its net capital, from levels below 5.0% a month earlier. However, this increase, the shorter duration of bank portfolios in subsequent months (fall to 1.7 years in May) and the lower volatility of financial markets, mean that we envisage a fall in market risk in subsequent months.

Development banking and development institutions (10.6% of financial system assets) also showed financial robustness in the first quarter of the year, although they recorded a slight decline in their indicators with respect to the end of 2019. In March, the capitalization index of development banking stood at 18.24%, a 0.9% drop compared to last December. In terms of credit risk, the past-due portfolio rose from 2.22% to 2.40% between March 2019 and March of this year. This level is the result of 85% of the portfolio focusing on high credit ratings at the end of the first quarter. Currency depreciation influenced the growth of the sector's financing balance, similarly to what happened with commercial banks. In fact, during the first quarter, it registered a growth of 1.4% with respect to the same period in 2019, mainly influenced by Bancomext's high foreign currency credit exposure (81.2%). It should be noted that March's growth is the first positive quarterly growth rate for a year. Finally, Banxico highlights the case of the Banco del Bienestar, not only due to it being the only development bank that registered a net capital increase of MXN 5.3 billion in 2019, but because of the potential operational risk from the renewal of its executive staff and the ambitious strategy it is dealing with.

The volatility of the financial markets was particularly reflected in the performance of the pension funds (16.3% of the assets in the financial system) and investment funds. In the first case, significant losses were registered in March, which even exceeded those observed in October 2018 after the cancelation of the NAIM as a percentage of the administered assets. However, these losses were reversed between April and May with the recovery in the prices of risky assets, particularly the stock markets. In this regard, Banxico notes that regulatory changes due to the transition from the multi-fund system to a scheme based on Generational Funds were reflected in an increase in foreign equity and debt securities investment at the expense of a reduction in fixed-rate government instruments. This increased exposure to foreign equity influenced the volatility in yields observed in March and April. In addition, the central institute notes in its report that in the period January-April, about five billion pesos were withdrawn as unemployment support for assets administered by the pension funds. This constituted just 0.13% of the total assets managed; nevertheless, it is a clear effect of the pandemic that needs to be considered.

On the other hand, mutual funds (10.3% of the financial system's assets) performed differently. While, during the first quarter of the year, assets managed by equity funds fell by 21 billion, fixed income assets increased by about 83 billion. This resulted in the share of fixed income funds with respect to the total sector-managed funds rose from 75.1% last December to 76.5% in March 2020. One point that the central bank highlights is the fact that until May there had been no significant repayments at the system level, in contrast to other periods of stress, such as those in 2008 and 2016. This can be attributed to the fact that this time the main factor of uncertainty is related to the duration of the pandemic, among other factors, and not to the quality of investments or the funds' assets.

For brokerage houses (3.4% of the financial system's assets) market volatility at the end of the first quarter had a marginal impact. The reduction in direct exposure to long-term fixed income instruments made it possible to reduce the sensitivity of the portfolios to market movements. In this way, market risk in this sector even fell during the first quarter of the year. Thus, at the end of March, assets managed by this type of intermediary grew at a real annual rate of 18.2%.

As for the insurance sector (7.0% of the financial system's assets), Banxico indicates that it has reserves that are sufficiently liquid to deal with the risks associated with the pandemic without compromising the stability and solvency of the sector.

While the main message of the report is that, as of the date of its publication, the financial system's conditions were robust enough to deal with the economic and financial shocks resulting from the pandemic, Banxico highlights four risks that could intensify: (i) the slowdown in the global economy and the uncertainty associated with its recovery, (ii) an increase in financial market volatility and global portfolio rebalancing towards lower risk assets; (iii) further contraction of the national economy than the global economy and uncertainty about its depth and duration; (iv) further rating cuts to the sovereign debt and PEMEX's.

Based on these risks, the central institute conducted stress tests to identify potential vulnerabilities in the banking system in the face of extreme conditions. The results indicate that in none of the six simulated scenarios would the system's capitalization index as a whole be below the regulatory minimum of 10.5% in the next three years. However, it is emphasized that some institutions, which together account for a low percentage of the system's assets, could see their capitalization level fall below the minimum.

Infonavit's higher delinquency rate is the result of good accounting practice

At the end of November last year, Infonavit (the Instituto Nacional para la Vivienda de los Trabajadores — Mexican National Institute for Workers' Housing) announced a reclassification of 116,000 credits in the past-due portfolio forming part of its overall portfolio. This was done in order to meet the implementation requirements of the IFRS (International Financial Reporting Standards). The result of this adjustment was that the past-due portfolio increased at the end of 2019 to 171 billion constant pesos, representing a delinquency rate of 12%. Nevertheless, the reclassification of these 116,000 loans as overdue is consistent with good accounting practices and greater transparency.

Even though there was a deterioration in the Institute's delinquency rate due to the so-called reclassification, the balance of the extended portfolio also increased significantly during 2019, prior to the outbreak of the COVID-19 pandemic. Between August and December last year it increased by an average of 20.5% in real terms, and as of the end of the first quarter of 2020, it has grown by an average of 15.3%.

The fact that the Institute's impaired portfolio, taking into account the extended portfolio, has been exceeding 12% for several years is undoubtedly a cause for concern, because this has reflected the fact that, despite the institution's efforts to increase the denominator via the current balance through greater financing origination, this has not been successful in recent years, even though it increased the maximum credit limits in order to achieve stronger penetration of the medium-income residential market, a practice that was rightly abandoned under the current administration. Moreover, the marked slowdown in the generation of formal employment, as recorded by the IMSS (Instituto Mexicano del Seguro Social — Mexican Social Security Institute), which had only increased by 1.4% at the end of 2019, and the potential loss of 1.5 million jobs this year could cause the Institute's financial situation to worsen.

Credit to agricultural and industrial activities accelerates in 1Q20

According to the Bank of Mexico's Regional Economies Report, the current portfolio of non-financial private companies in commercial banking registered a real annual increase of 10.4% in 1Q20. Bank financing in the central region of the country, which accounts for 57% of the credit, contributed 4.9 of these 10.4 percentage points (46.8%).

The increased credit intermediation presented in the document includes the first weeks of restrictions on non-essential activities due to the COVID-19 pandemic. In addition, the percentage of companies that reported the use of bank credit to finance their activities was 36.5%, increasing throughout the country with the exception of the Northern region, where other sources of financing (own funds and providers) also contracted.

At the sectoral level, agricultural activities showed a greater increase in the Central and North Center regions of the country with rates of 18.9% and 22.1%, respectively. Industrial activities showed the highest growth in the North and South regions with growth of 15.8% and 24.9%, respectively. The credit performance mentioned in the report impacts the intermediation margin of commercial banks, contributing to a better expectation of quarterly performance of financial services and insurance GDP during 1Q20, consistent with the IGAE data.

According to our forecasts, sectoral dynamics in the different regions point to harsher effect in 2Q20, especially in the industrial and services sector. Support programs by banks could mitigate the expected increase in the delinquency rate in the short term. However, the lower revenue from such activities will undoubtedly have an impact on the demand for loanable funds and thus on the performance of commercial banking and the financial services sector as a whole.

2. Financial Markets

The new outbreak of COVID-19 in the US leads to slight market caution. The Mexican peso stands out negatively in June

The history in the markets in June can be divided into two parts. Until June 10, financial markets maintained the bullish mood observed since March 24, supported by the narrative that the worst of the pandemic was over, and recovery was on the doorstep. The announcement of a new outbreak in China and a significant increase in COVID-19 cases in several US states following reopening triggered a strong episode of risk aversion on June 11. This was followed by volatile sessions in which market participants contrasted the assumptions of the prevailing recovery narrative with the dynamic of the pandemic and economic data.

The contrast between the two halves of June was made clear by the price performance of the majority of the underlying assets. In the case of stock markets, a significant risk-taking was observed during the first third of the month exacerbated by retail investor participation. In contrast, during the rest of the month, the various risk aversion episodes were reflected in losses. The benchmark for this asset class at a global level (MSCI World) was up 5.6% during the first 10 days of the month while the rest of June saw a fall of 4.0%. This resulted in a cumulative yield of 1.3% as of June 29. Within the regions, investors preferred positions in emerging markets at the expense of lower exposure to the US market, in the face of the new outbreak of COVID-19 cases. Thus, during the first third of June, the S&P500 and MSCI EM were up 4.3% and 8.8%, respectively, while during the rest of June, until the 29th, growth was -4.3 and -1.8%, respectively. The IPC showed similar behavior to that observed in the emerging-country indices, which led it to close the sixth month of the year with an increase of 4.6%.

In the exchange rate market, the US dollar benefited from increased demand in the face of risk aversion after depreciation at the beginning of the month. Against developed currencies, the dollar accumulated an appreciation of 0.8% in the month up until June 29, after falling 2.4% in the first 10 days of the month. The behavior of EM currencies was very similar. Within this group, however, the Mexican peso stood out negatively. As of June 29, the Mexican

currency accumulated a monthly depreciation of 4.0%, after registering an appreciation of 1.5% during the first third of June. This 4.0% depreciation made it the most depreciated currency among EM's in June and the third most depreciated currency so far in 2020, only behind the Brazilian Real and the South African Rand. As such, the exchange rate is again above 23 pesos per dollar. In addition to the observed depreciation, implied volatility remains close to 20%, which is an obstacle with regards to carry trade strategies.

In the fixed-income market, Treasury bond rates closed the month unchanged after the members of the FOMC showed in their forecasts that they expect the federal funds rate to remain at current levels until 2022. In Mexico, the yield to maturity of the 10 year Mbono fell 24 basis points between June 11 and 29 to 5.9%. In the context of unchanged Treasury yields and a greater implied exchange-rate volatility, this drop in performance could be explained by two factors. On the one hand, a 14bp reduction in sovereign risk, measured by the five-year CSDspread. On the other hand, expectations that the monetary policy rate could be further reduced. Currently, the monetary policy rate implied by the IRS curve points to 4.0% at the end of 2020.

In the commodities market, news of the new cases of Coronavirus, mainly in the US, led to a reduction in price growth that had been observed weeks ago as the expectations of persistent oversupply resumed. For the benchmark of this asset class (S&P GSCI Index), an increase of 6.6% was recorded in the first 10 days of the month. During the rest of the month (until June 29), there was a fall of 0.9%. In the case of crude, and particularly the Mexican mix, there was an increase of almost $5 in June (15.5%). This increase was almost entirely the result of an increase of 15.3% during the first days of the month, as the price barely increased by 0.2% between June 11 and 29.

The increased likelihood that a second wave of infections materializes in the US has led investors to evaluate the assumptions of the rapid recovery narrative that has prevailed among market investors since the end of March. Recent market sessions have pivoted between gains and losses as participants weigh up news about the outbreak and new economic data. The recovery narrative seems to need an additional catalyst to dispel doubts about its assumptions, especially in the face of the coming expiration of wage support in the US. We will have to keep a close eye on whether the US Congress manages to give a new impetus to this rapid recovery narrative despite the pandemic's persistence.

3. Regulation

Expansion of Covid-19 emergency support measures

On June 29, the CNBV issued a statement informing of a one-month extension of the special accounting criteria that have enabled the credit institutions' customer support programs (grace periods of up to six months without being classified as past-due or restructured loans). The 120-day deadline that was originally established for receiving and handling requests for restructuring had expired on June 26 and will now be extended to July 31.

Banxico: implementation of the response to the Covid-19 crisis

The Bank of Mexico issued a series of circulars in June related to the implementation of the additional measures of April 21, which are additional to the measures of March 20 to deal with the effects of the health emergency and focus on providing liquidity to markets and strengthening credit channels.

Thus, on June 2, the following circulars were published: 19/2020, addressed to credit institutions, brokerage houses, investment companies, Siefores and the National Financial corporation for Agricultural, Rural, Forestry and Fisheries Development, on modifications to the Repos Circular; 20/2020, concerning the provision of resources to commercial and development banks to channel credit to MSMEs and individuals; 22/2020, which states that the minimum payment amounts that entities are required to collect in respect of credits, loans or cards shall correspond to the payment periods applicable from October, allowing them not to charge payments corresponding to April-September (in line with the banks' customer support plans); 25/2020, concerning the financing guaranteed with the bank's qualified credit assets to be channeled to the MSMEs; and 26/2020 aimed at credit institutions and focused on credit auctions in US dollars.

Accounts for individuals over the age of 15

In addition to the amendments to the Credit Institutions Law (LIC), made in March to allow minors to open and operate savings accounts without the intervention of third parties, on June 5, the Bank of Mexico issued circulars 23/2020 and 24/2020 defining the operational characteristics of these accounts (denominated in pesos, deposits for up to 3,000 Investment Units per month and by electronic transfers from government programs or employers, among others), as well as forbidding the charging of fees.

Similarly, on June 9, the rules of Article 115 of the LIC (Rules for the Prevention of Money Laundering) were revised with the aim of adjusting them in relation to accounts of people over 15 years of age, noting that they will be considered low risk and defining the integration of their files, among other things.

Finally, on June 9, the adjustments to the Circular Única de Bancos (Single Bank Circular) were published with the aim of obtaining consent from minors so that the institution can notify their parents or guardians of the opening of accounts and inform them that they can request and consult bank statements and movements.

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