Banking

Monthly Report on Banking and the Financial System

Fernando Balbuena / Alfonso Gurza / Iván Martínez Urquijo / Mariana A. Torán / Samuel Vázquez

August 3, 2020

1. Banking and the Financial System

In May, consumer loans registered their first fall in nominal terms since August 2010

In May 2020, the balance of existing credit granted by commercial banks to the non-financial private sector (NFPS) grew at a nominal annual rate of 8.2% (5.2% real), which is below the rate seen in the previous month (11.2%) and the nominal rate of 8.9% reported in the same month of 2019. This result was mainly due to the performance of business loans, which, despite slowing down from the previous month, managed to maintain a double-digit growth rate. By contrast, consumer loans saw a worsening of the slowdown reported in previous months, and registered a fall in nominal terms for the first time since August 2010. Finally, mortgage loans continued to show a reduction in growth, failing to reach double-digit nominal growth rates for the third consecutive month. Based on this performance, the contribution made by the components of total bank credit to the growth of 8.2 percentage points (pp) reported in May was as follows: business loans contributed 6.8 pp; mortgage loans, 1.7 pp; and consumer loans the rest of the growth, at 0.3 pp.

The observed growth continues to be based on the performance of business loans, which owes some of its dynamism to an accounting effect associated with the depreciation of the exchange rate. In addition, business loans experienced faster growth due to the use of credit lines to meet short-term liquidity needs. In the future, this accounting effect may continue to be observed but an additional impetus may be associated with the need for companies to finance their working capital, to remain in business. Other structural factors that could drive a higher demand for loans continue to deteriorate, as shown by the contraction of the gross capital formation indicator. In the case of consumer and mortgage loans, their future performance is linked to the severity of the job losses and the deterioration of households' ability to pay. Both factors point to greater caution by agents in acquiring medium- and long-term payment commitments, which will negatively affect their demand for loans.

Bank deposits are being driven by the greater precautionary saving due to the pandemic

The balance of banking system deposits fell 1.8% in nominal terms between April and May, mainly influenced by a currency appreciation compared to the previous month that reduced the value of foreign currency balances (16% of traditional deposits). Even with this monthly reduction in May, the annual growth rate of traditional deposits (demand + term) remained at double-digit levels (13.9% nominal) due to the extraordinary increase in prudential saving observed in March and April as a result of the pandemic.

Within this fall in the balance of traditional deposits, what stands out is the differentiated behavior between economic agents. The deposits of individuals increased in aggregate in May, possibly driven by lower consumption resulting from the lockdown measures. In contrast, companies have begun to make use of their liquid resources on the aggregate. That is, companies have started spending their saved resources to cover their current expenses and liabilities in a lower-income environment.

At the moment, deposits have been extremely resilient to the adverse economic environment. However, we believe that, to the extent that the effects of the recession become apparent in the coming months, particularly in terms of the loss of formal jobs, we could see a significant reduction in the balance of bank deposits, even taking into account the possible changes in consumption and saving patterns resulting from the pandemic.

The National Banking and Securities Commission (CNBV) designates domestic systemically important commercial banks

In accordance with current regulations, in April 2016 the CNBV's Governing Board approved the designation of commercial banks considered to be of domestic systemic importance. These banks were required to put in place 100% of the respective additional capital buffer within a maximum period of four years, with 25% of the capital increase being constituted each year. This is in addition to the 10.5% minimum capitalization ratio currently required for commercial banks. Each year, the CNBV assesses the commercial banks to determine whether they should be designated as of domestic systemic importance.

In July 2020, the CNBV reported that, at its Governing Board meeting held in March and taking into account information at the end of December 2019, it has designated six commercial banks as of domestic systemic importance (Scotiabank, HSBC México, Banco Mercantil del Norte, Banco Nacional de México, Banco Santander México and BBVA Bancomer). In addition, it determined their level of systemic importance and the corresponding capital conservation buffer. It should be noted that, as a result of the evaluation carried out, one of the banks (Banco Inbursa) is no longer considered of domestic systemic importance.

BIS annual economic report

In its annual report, the Bank for International Settlements (BIS) conducts an analysis of the impact of the COVID-19 pandemic on the financial system, with a special emphasis on the performance of the monetary authorities.

The first part of the publication reviews the impact on markets and the authorities' reactions to the sudden disruption of global economic activity generated by measures to contain the pandemic. **Beyond the review of the economic growth figures, the BIS draws attention to preexisting vulnerabilities that have been exposed as a result of the recent financial volatility and that have made it difficult to implement public policies to tackle the economic consequences of the pandemic**. The first is the fragility of the balance sheets of both households and companies after non-financial private sector debt increased globally from 120% of GDP before the 2008 global financial crisis (GFC) to 144% of GDP in December 2019. In the case of households, the increase in debt is largely explained by the behavior of countries such as China and some developed countries such as Australia. This contrasts with the debt reduction of households in the countries that were at the heart of the 2008–2009 housing crisis (US, Spain, UKand the

Netherlands). In the case of non-financial companies, not only has been a significant increase in debt in several countries (the corporate sector in Canada, France, Switzerland and Turkey recorded increases in their debt of around 30% of GDP between 2011 and 2019, while in the US, the increase is about 10%); but income for debt servicing has fallen since 2010 and the balances of these debts in foreign currency have gone up.

The second vulnerability highlighted by the report is the strong dependence of non-financial companies on capital-market financing (the amount of corporate bonds in circulation reached USD 16 trillion, most of which was issued by speculative grade companies). The current environment of lower income and greater financial volatility has damaged the credit profile of companies (as of May, the number of reductions in credit ratings and outlooks by rating agencies grew to almost 1,800) and has led to the sale of debt positions by institutional investors, as well as to redemptions of investment funds in general. All of this weakens the financing conditions of companies.

In addition, the report highlights that the global banking sector has been able to adequately address the recent increase in demand for precautionary loans from both households and businesses, supported by the increases in capital requirements above the minimum observed since the GFC. However, the shock of the pandemic has put pressure on the banking system on several fronts. On the one hand, the increase in credit risk has forced it to increase its provisions. During the first quarter, the European banks increased their provisions by a factor of four, while European banking allocated twice as many resources to this purpose during the first three months of the year. The adequacy of these resources will be tested in the coming months, particularly given the fall in the price of commercial property in the sectors most affected by the pandemic. On the other hand, the volatility seen in March significantly increased bank debt spreads and led to the revising of the debt rating outlook for several banks. This has led to greater pressure on the sources of financing for the banks that do not have a solid base of deposits from the public.

In terms of the response of the authorities to the shock caused by the pandemic, the BIS notes that, in contrast to a conventional recession, the priority should be to ensure that viable households and companies survive the sudden disruption of economic activity, while avoiding a sharp reaction in the financial markets that puts financial intermediation at risk and worsens the recession. This situation can be equated to that of taking the necessary measures to keep a patient's vital organs functioning while they are in an induced coma. This response by the authorities highlights the involvement of the central banks through the implementation of conventional and unconventional monetary policy measures (e.g. interest rate cuts and asset purchases) to add liquidity to the system, as well as prudential measures to support banking intermediation (e.g. to make use of the unused resources accumulated in times of stability and to relax the minimum regulatory requirements). In this respect, Mexico compares favorably with developed and emerging countries, since, apart from the purchase of assets, the monetary authorities have taken all the measures in their powers.

While noting the importance of the measures described, the report highlights that they are restricted to only providing temporary financing and cannot permanently transfer resources to the pockets of economic agents to reduce income shortages, in the way that fiscal policy can. In contrast to the position with measures taken by the central banks, Mexico compares unfavorably with emerging and developed countries in its response to the crisis by the fiscal authorities. Household support measures were limited to tax deferment, and there has been no action on direct transfers, unemployment benefits or wage subsidies. In the case of companies, support was also limited to tax deferment, while tax guarantees, direct transfers and tax cuts were not implemented. Indeed, according to BIS figures, Mexico's budgetary support measures amounted to less than one pp of GDP, while the average for the emerging countries was about 3 pp of GDP.

Beyond the scale of fiscal and monetary support, the publication emphasizes that the final test of the authorities' response will be the strength and speed of the recovery. The BIS recognizes that most analysts expect a V-shaped recovery, but it points out that data from China's experience point to a U-shaped recovery in which supply recovers first through the reactivation of large companies, while smaller businesses lag behind and demand stays depressed for longer. However, it does not rule out a W-shaped recovery, in the face of possible further outbreaks that require the imposition of lockdown measures. Finally, the publication warns of the importance not only of managing crises (e.g. dealing with liquidity problems), but also of resolving them (e.g. dealing with solvency problems). This is important given that high levels of debt, loss of capital from the bankruptcy of viable firms, and loss of skills resulting from long periods of unemployment could lead to lower growth in the medium and long term.

In its second section, the BIS annual report focuses on the analysis of the measures taken by the central banks to deal with the crisis caused by the pandemic in the context of the development of the global financial system. **The main premise is that the central banks have had to extend their range of intervention beyond the financial institutions, to the point that, particularly in advanced countries, the central banks have acted not only as lender of last resort, but also as dealer of last resort**.

The broader range of action taken by the central banks in the recent crisis goes hand in hand with the greater importance of market financing over the last decade, particularly for corporations. In fact, the data in the document indicate that the share of non-banking financing of corporations in the emerging markets (EMs) has increased by about 10% between 2008 and 2019, while in the developed countries this increase has been slightly lower. Mexico stands out among the sample of EM and developed countries presented by the publication, as it is the country with the second largest increase in non-bank financing of corporations in the last eleven years, behind Spain. In addition, it is the country whose corporations use the lowest proportion of bank loans within their financing, at around 40% (a position it shares with the US).

Given the greater importance of non-banking financing, the response of the central banks to retain the stability of the financial system had to incorporate various liquidity-providing mechanisms focused on various segments of the financial market such as corporates, municipalities and investment funds. A clear example of a liquidity provision mechanism was that adopted by the FED to support money market investment funds. The increase in risk aversion during March generated settlements of US money market funds of about USD 160 trillion (15% of assets under management) with its consequent upturn in financing costs and fall in emissions. These funds are key to the demand for commercial paper, which is an important source of short-term financing for corporations and companies in general. Moreover, they have a global dimension, as US money market funds are a source of dollar financing for companies around the world. The establishment of a liquidity facility by the FED halted the redemptions and restored the operation of this market, as well as reducing the shortage of dollars in the market.

In addition to the establishment of liquidity-provision facilities, the central banks incorporated the purchase of assets, but this went well beyond government bonds to include private sector assets. Most developed-country central banks implemented or expanded the amounts available for the purchase of commercial paper, corporate bonds and mortgage bonds. The FED even extended its range to the purchase of municipal bonds and some speculative grade bonds (high yield). The speed of implementation and broad coverage of these measures succeeded in bringing liquidity to the markets and reducing differences in yields compared to risk-free assets.

This liquidity provision had a global reach for the central banks with a currency of global importance, such as the FED. The dominance of the US dollar in market transactions is clear from the fact that between 2000 and 2019, bank

liabilities outside the US grew from USD 3.5 trillion to USD 10.3 trillion, while those of banks outside the US have doubled in recent years to around USD 12 trillion. To this we can add the large number of dollar loan transactions taking place in derivatives markets. The sharp increase in risk aversion caused by the pandemic generated strong demand for dollars, while supply evaporated in the face of the pressures on bank financing and the inability of offshore institutions to obtain dollars.

To ease the dollar shortage, the FED re-established the swap facilities implemented during the GFC and opened new facilities with nine other countries. In addition, the FED launched a new facility whereby countries can use their Treasury bond reserves as collateral for dollar financing. Since their announcement, these measures have succeeded in reducing costs and in general re-establishing the operation of the dollar-financing market.

One point that is again highlighted in the publication is the absence of tensions in the interbank market in the present crisis. Unlike in 2008, counterparty risk between the banks has not been a concern, largely due to the significant accumulation of capital and liquidity provisions after the GFC. The greater strength of the banking sector this time has been reflected in the very slight divergence between the benchmark rates in the money markets and the monetary policy rate.

Although the theme of this second part of the publication is the broader spectrum of market segments addressed through the central bank policies given the evolution of the financial system, the BIS emphasizes the continued importance and centrality of the banking system today through two elements. The first is the implementation of regulatory and prudential measures aimed at avoiding deleveraging by the banks that could jeopardize the intermediation of funds. To this end, central banks and authorities in different countries relaxed capital and liquidity requirements and encouraged the use of resources accumulated for precautionary reasons. In emerging countries, reserve requirements were cut and even eliminated. In addition, some countries restricted the payment of dividends to shore up bank resources (e.g. Mexico) and implemented a program of guarantees of up to 100% of loans to encourage loans by banks (e.g. Germany, Switzerland and Hong Kong).

The second element is the emphasis on the idea that the banking system and the markets complement each other, particularly in times of crisis. To illustrate this, the publication notes that when financing from the financial markets almost dried up as a result of the crisis in March, companies immediately turned to credit facilities. This demand reached such a point that business and industrial loans granted by US commercial banks increased by 30% (USD 700 trillion) between March and May of this year. Thus, this crisis showed that it was the banking system, not the capital markets, that assumed the role of a “spare tire” in the financial system.

Finally, the BIS looks to the near future and warns of the significant challenges facing the monetary authorities. In an economic context characterized by downward pressures on inflation, higher public debt and a possible lower capacity of the banking system to sustain recovery in view of solvency problems, it emphasizes that there may be greater pressure for monetary policy to provide more support in terms of achieving greater economic growth. At this point, the BIS makes clear that **monetary policy cannot be the driver of sustained growth, since the inappropriate and excessive use of its instruments may lead to the creation of vulnerabilities and imbalances in the financial system that could affect the economy in years to come. It argues that the large-scale intervention of the central banks in the debt markets can only be sustained to the extent that it meets the objective of stabilizing the system and provided that it comes with a clear exit strategy**. Using monetary policy beyond its objectives risks eroding credibility, which is the main asset of the central banks.

The banking sector's mortgage loan origination fell 18.2% in real terms

At the end of May 2020, the amount of mortgage financing granted by commercial banking had recorded a cumulative fall of 18.2% in real terms.[1] In our April report we pointed out that, on the basis of leading consumer confidence indicators, the demand for mortgages would decline this year. This, coupled with the crisis caused by COVID-19, began to manifest itself more strongly at the close of the first quarter with a double-digit contraction in mortgage activity.

As of March, the last available data, the general original series consumer confidence index fell by 9.2%, while confidence in purchasing durable goods and housing declined by 6% and 1.3% respectively.

Confidence is expected to continue to fall in the months to come, given that the loss of formal jobs could affect up to 1.5 million workers during 2020. According to Mexican Social Security Institute (IMSS) data, formal employment, the main determinant of housing demand, fell by 3.9% in May, but could close the year with a contraction of almost 7%.

As a result, we are looking at mortgage demand stagnating in 2020, owing to zero economic growth in 2019 and the current crisis. In addition, that effect will be maintained during 2021 with depressed demand for mortgage loans, given the lagged effect of this year's job losses. We estimate that banking mortgage origination could contract between 15% and 20% this year with a downward bias, and could recover by the end of 2021 or start of 2022.

2. Financial Markets

Adverse economic effects of the new COVID-19 outbreaks in the US result in slower recovery at the end of July

In the financial markets, July was characterized by signs of slower recovery in economic activity as a result of new outbreaks of COVID-19, particularly in the US.

The narrative of a rapid (V-shaped) recovery in an environment of low interest rates over a long period and continued significant risk-taking by small investors (retail investors), taken together, remained the driving force behind market movements, even though the new outbreaks of COVID cases have been increasing for several weeks in many US states. However, market participants paid more attention to the pandemic's resurgence toward the final third of the month, after unemployment claims in the US increased for two consecutive weeks and in the absence of agreements among US legislators to extend the employment tax support that expires at the end of the month. In this way, the final days of July saw episodes of risk aversion that were reflected in the prices of risk assets.

Most equity markets increased their gains in July but decelerated at the end of the month. The global benchmark for this asset class increased 4.6% between June 30 and July 30, while the S&P500 rose 4.7% over the same period, resulting in a positive performance during 2020. In the latter case, it should be noted that the recent recovery in the index is largely associated with the rise in the shares of technology companies to such an extent that, so far this year,

1: Note: the adjustment factor is based on the Federal Mortgage Company housing price index; Base 2017 = 100. It estimates annual inflation of 6% in May.

the shares of Facebook, Apple, Amazon, Microsoft and Google (Alphabet) have increased by 35%, while the remaining 495 shares making up the S&P500 have fallen in price by 6.6%. In the case of the benchmark stock index for emerging countries, growth accelerated to 8.7% between June 30 and July 30 in the face of a global search for returns, while Mexico's IPyC again performed worse than the rest, falling by 1.5% in the same period.

In the bond market, the two-year Treasury bond yield on maturity fell 2 bp between June 30 and July 30 following the FED's reiteration of its extraordinarily accommodative stance over a long period of time. In the long part of the curve, the highlight was the negative yield in real terms recorded for the first time ever by the 30-year Treasury bond. This means that, contrary to expectations in the stock market, the fixed income market is expecting economic growth to remain weak for a long time. In Mexico, the yield to maturity of the 10-year Mbono fell 14 basis points between June 30 and July 30. This is in line with the 8-bp fall in the 10-year Treasury bond yield over the period and non-significant variations in market expectations, which indicate that the monetary policy rate will end at about 4.0%.

This low-rate scenario, along with the narrative around rapid recovery that was in place for most of July, was reflected in significant movements in the relative price of the dollar and gold. The US currency recorded its weakest level since 2019 compared to developed currencies, after falling 4.5% between June 30 and July 30. This movement was influenced by the appreciation of the euro after a fiscal aid package of EUR 750 billion was approved. In response to the dollar's widespread depreciation, the expectation of low interest rates over the long term, and the risks associated with the new outbreaks of COVID cases, there was a sharp increase in the price of gold (7.9% between June 30 and July 30). This was clearly above the 3.8% growth of the global commodity benchmark (S&P GSCI). With this increase, the metal rose to a new record high. It should be remembered that gold is an asset that does not generate returns and that is seen as a safe asset in times of great uncertainty, so the low opportunity cost of the current scenario favored higher demand for this metal.

The dollar also depreciated against emerging-country currencies. The benchmark for this set of currencies (JP Morgan EM currency index) appreciated 3.1% between June 30 and July 30, while the Mexican peso stood out within this group. In the period indicated, the Mexican currency appreciated 4.2% and this appreciation was even higher before the second consecutive increase in unemployment claims in the US was reported. In this way, on some days during the month the exchange rate was priced below 22 pesos per dollar for the first time since mid-June. At the end of the seventh month of the year, the exchange rate was again above 22 pesos per dollar, ranking it eighth in the list of most appreciated currencies during the month and fifth in the list of most depreciated so far in 2020.

The effects of the new outbreaks of coronavirus cases in the US began to be felt in the economic data at the end of July. As noted last month, this has led many investors to examine more closely the assumptions of the prevailing narrative of rapid economic recovery and has generally been reflected in lower gains in risk asset prices. At this point, the narrative needs to be reinforced by an additional catalyst that dispels doubts about its assumptions. Market participants seem to be factoring in the fact that this catalyst could be the extension of the fiscal support deadline in the US. However, some hours after these support programs expire, there is still no agreement in the US congress, opening the door to a month of August which, exacerbated by low trading volumes, could be characterized by high volatility.

3. Regulation

Banxico's adjustments to interest rates in open market operations

On July 15, Banco de México made adjustments so that the interest rates applicable to operations associated with liquidity or deposit auctions move in parallel with the adjustments to the target monetary policy interest rate. According to the central bank, the adjustment provides certainty that the rates to be paid or received are consistent with the target rate throughout the life of the operations, generating incentives for participation in the auctions and facilitating the Banco de México's liquidity management of liquidity.

Maturity renewal for corporate debt repos

In view of the impact of the COVID-19 health emergency on uncertainty and risk, as well as its effects on the functioning and liquidity of the secondary market for corporate debt, on July 23, Banco de México published adjustments to allow the renewal of three-month corporate debt repos issued between July 16 and December 31, 2020. The maturities may be extended until 2021 when the securities under the repurchase agreement represent between 5% and 10% of the total nominal value of the series without exceeding 75 million Investment Units (UDIs), and until 2023 when the holding exceeds 10% of the total issue or alternatively exceeds 75 million UDIs.

Temporary adjustment to the threshold of level 2 accounts

In view of the effects of the health emergency, particularly the rising demand for payroll and personal loans, on July 14 the Secretariat of Finance and Public Credit decided to raise the maximum amount for monthly deposits for level 2 accounts, from the 3,000 UDIs in force to 15,000 UDIs. It should be recalled that the identification files for level 2 accounts only contain data (full name, without abbreviations, date of birth and address), which can be obtained remotely, which is good given the public health situation, as well as convenient for the banks, and will facilitate their expeditious granting.

DISCLAIMER

This document was prepared by Banco Bilbao Vizcaya Argentaria's (BBVA) BBVA Research and BBVA Bancomer S. A., Institución de Banca Múltiple, Grupo Financiero BBVA Bancomer on behalf of itself and is provided for information purposes only. The information, opinions, estimates and forecasts contained herein refer to the specific date and are subject to changes without notice due to market fluctuations. The information, opinions, estimates and forecasts contained in this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA Bancomer, and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. This document is not an offer to sell or a solicitation to acquire or dispose of an interest in securities.