Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Business loans lose momentum in June from higher liquidity demands seen in previous months

In June 2020, the balance of performing loans granted by commercial banks to the private sector grew at a nominal annual rate of 6.5% (3.0% real), down from the nominal rate seen in the previous month (8.3%) and the nominal rate of 8.5% recorded in the same month of 2019. This meant two consecutive months of slowdown after the upturns seen in March and April 2020 (with nominal growth of 10.4% and 11.2%, respectively). As in previous months, the growth experienced was primarily due to the performance of business loans. Conversely, consumer loans exacerbated the slowdown seen since October 2019, with a contraction in nominal terms for the second consecutive month. Finally, mortgage loans continued to show a reduction in growth, failing to reach double-digit nominal growth rates for the fourth consecutive month. Based on this performance, the contribution made by the various components of total bank credit to the growth of 6.5 percentage points (pp) recorded in June was as follows: business loans contributed 5.5 pp; mortgage loans, 1.7 pp; while consumer loans reduced their growth, by 0.7 pp.

About half the growth in business loans continues to be associated with accounting adjustments for the depreciating exchange rate. In addition, the momentum seen in previous months from companies having been granted lending facilities to increase their access to liquid resources continues to slow down. Other drivers that could boost the demand for business loans continue to show a sharp decline, such as the gross fixed investment indicator and the confidence index on the right time to invest. The performance of consumer and mortgage loans is beginning to reflect the negative impact of the formal jobs loss and the reduction in household income. In the medium term the recovery of these variables will be closely linked to the banking loans performance.

Deposits in the banking system are slowly beginning to fall from high levels

The balance of traditional deposits in the banking system remains high following the currency depreciation and the rise in precautionary saving due to the pandemic. However, the effects of the economic downturn are gradually starting to be reflected in the drawing down of these resources, particularly in relation to the term deposits of both companies and individuals. The category of deposits that has continued to grow is demand deposits by individuals. This undoubtedly raises the possibility that the lower consumption of people who have retained their jobs has, for the moment, offset the reduction in balances resulting from the fall in formal employment.

As a result, traditional deposits grew 0.4% (-0.1% real) between May and June, boosted by a 0.6% (0.1% real) monthly growth of the demand segment and a 0.1% (-0.4% real) increase in term deposits. Compared to the same month in the previous year, the nominal growth rate of traditional deposits in June was 12.4% (8.8% real), reflecting the positive base effect on the figures from the aforementioned growth in deposits resulting from the pandemic. The annual comparison is expected to also reflect high rates, although these will tend to slow down during the second half of the year.

While the continued growth in saving by individuals was unexpected, it seems unlikely that this will continue over the coming months given the lower labor demand. As a result, we would still expect the balance of bank deposits to fall at a faster rate over the coming months as the effects of the economic downturn are felt more strongly.

CNBV (*Comisión Nacional Bancaria y de Valores* — National Banking and Securities Commission) publishes an update of the Liquidity Coverage Ratio (LCR)

CNBV published the simple average of the daily LCR calculations reported by commercial banks for the April-June 2020 quarter. All of the banks complied with the required Liquidity Coverage Ratio (LCR), in accordance with the provisions and applying the exceptions envisaged to deal with the COVID-19 pandemic, effective from February 28 to August 31, 2020.

The Commission clarified that, of the 51 banks in operation, 50 provided information on time and in the right format, in accordance with the provisions applicable to the sector. Banco Ahorro Famsa, S.A., a commercial bank, did not comply with the regulatory framework as it did not submit the required quality of financial information for the reference month. Therefore, the figures presented do not include the LCR of that bank. Taking this into account, the median LCR in the reference month was 224.39%.

In the first quarter of 2020, total financial savings grew 7.6% in real terms and total financing grew at a rate of 7.4%

CNBV published an update of the Financial Savings and Financing in Mexico report, with figures from the first quarter of 2020 (1Q20). In the reference period, total financial savings showed a real annual variation of 7.6% and represented 101.8% of GDP. The domestic component of financial savings showed a real annual growth of 6.5% and was equivalent to 70.6% of GDP. Within domestic financial savings, deposits of financial intermediaries (banks, savings and loans cooperatives [SOCAPs], popular finance companies [SOFIPOs], credit unions and development agencies and organizations) registered a real annual variation of 6.1% in March 2020 and their balance reached 35.6% of GDP. Most of the funds obtained are concentrated within commercial banks (23.3% of GDP), followed by Mexican federal institute for worker's housing (Infonavit) with 5.1% of GDP and development banking (3.6% of GDP). Foreign savings, meanwhile, showed a real annual variation of 10.0% and represented 31.1% of GDP. In the reference quarter, foreign savings received by the public and private sectors amounted to 20.0% and 11.1% of GDP, respectively.

Total financing experienced a real annual growth rate of 7.4%, equivalent to 104.1% of GDP in 1Q20. Domestic financing showed a real annual variation of 4.3% and represented 82.0% of GDP. Within this type of financing, the total lending portfolio showed real annual growth of 4.1% and its share reached 38.5% of GDP. Domestic debt and trust bond issues grew by a real annual rate of 4.6% in March 2020 and reached 43.5% of GDP, and the Federal Government continues to be the main underwriter of fixed income securities, with a balance equivalent to 26.7% of

GDP. In terms of foreign financing (of the private and public sectors) in 1Q20, the report indicates that this reached 22.1% of GDP and showed a real annual increase of 20.7%. By type of foreign financing, fixed income securities issued abroad reached 14.2% of GDP, while foreign loans represented 7.9% of GDP.

The financial system is stable and the banks' capitalization levels mean that they could cope with extreme unexpected losses

On August 26, the Bank of Mexico presented its Quarterly Report April-June. In this report, the Bank explains that its monetary policy actions have sought to ensure an orderly adjustment of the financial system to deal with the sudden increase in risk aversion, considerable contraction in output, fall in aggregate demand and uncertain inflation due to upward and downward pressures on it, driven by the impact of the pandemic at a global and local level. Against this backdrop, Banxico notes that the position of the financial system so far is stable. Even though, the financial system faces remains in a strong capital and liquidity position, and even when the financial authorities have implemented temporary regulatory measures, risks remain elevated. These risks, if aggravated, could affect the proper functioning of the financial system. This is why it is now more important to monitor these risks.

With respect to aggregate financing, the second quarter saw a slight increase in the Financing/GDP ratio in Mexico as a result of the contraction of GDP. In terms of the solvency of commercial banks, the capitalization index (ICAP) was higher in June (16.51%) than in March (15.66%) of this year. This level is primarily due to an increase in net capital, which, according to the report, is helping commercial banks to continue to tackle the pandemic from a position of strength. The report also notes that as CNBV revoked Banco Ahorro Famsa's operating license on June 30, the capitalization index for commercial banks does not take into account the information for that bank in the second quarter of the year.

In terms of the commercial banks' credit risk, the report offers three indicators of latent risks, and notes that the banks have the capacity to absorb unexpected losses due to default in their portfolios. The banks' credit risk, observed through the conditional value-at-risk (CVaR) at 99% confidence as a proportion of the loan portfolio, increased from 9.13% in March this year to 9.78% in June. By contrast, defaults on loans granted by commercial banks to the non-financial private sector (for residents and non-residents) measured by Non-Performing Loans index (NPL) fell from 2.69% at the end of the first quarter to 2.56% in June. This behavior is explained, in part, by the implementation of special accounting criteria (CCE) issued by CNBV under which eligible portfolios would be temporarily recorded as performing. Specifically, the NPL of loans granted to companies saw a reduction of 30 basis points from March to June in contrast to the delinquency rate for consumer loans, which showed an increase of 28 basis points in that same period. The capitalization index net of risk, which shows whether the banks' capitalization levels would allow them to handle extreme unexpected losses, has risen from 10.06% in March to 10.58% in June, remaining above the regulatory minimum.

The report shows positive signs with regard to the market risk of commercial banks, Specialized Retirement Fund Investment Companies (SIEFOREs) and investment funds, but remains cautious as to whether these conditions will continue. The market risk of the banks observed through the CVaR (Conditional Value at Risk) at 99% confidence as a proportion of net capital fell sharply to 3.69% in June, compared to 6.22% in March 2020. SIEFOREs reported positive cumulative returns up to May 2020. However, the drop in contributions made by workers and the rise in withdrawals due to unemployment is striking, as during the second quarter of the year the latter represented 7.5% of contributions deposited in SIEFOREs. Investment funds recorded system-level losses in the first half of the year, but of a non-significant nature, showing a net cumulative positive flow of MXN 35.6 billion for this same period.

The picture is still fragile with respect to the risks associated with non-bank lending intermediaries, private non-financial companies listed on the Mexican stock exchange (BMV) and Pemex. Since the beginning of the year, the delinquency of the loan portfolio of some non-bank lending intermediaries has been deteriorating. This trend is expected to continue due to the latent effects of the pandemic on the repayment capacity of their borrowers and has led to more flexible temporary regulatory measures, seeking to avoid higher expenditure on loan provisions. However, it is worth noting the reduced potential transfer of this risk to the commercial banks because of its low contribution within their total loan portfolios. In the second quarter of the year, financial companies listed on the stock market saw an increase in leverage and a fall in debt repayment capacity, very much in line with the fall in their income and the need to maintain certain levels of liquidity as a result of the pandemic.

Pemex's revenues declined while it faced financial debt and lease maturities in one year for MXN 348 billion or 13.6% of its total debt, a situation arising from Mexico's agreements with OPEC and reduced domestic demand for fuel as a result of the contingency plans. Lastly, in June PEMEX CDS spread stabilized, but still remains 200 basis points above the level observed in oil companies with a similar rating.

The adoption of the Special Accounting Criteria (CCE) has been important in mitigating the negative effects on the evolution of the loan portfolio

In its Quarterly Report, Banxico included an assessment of the adoption of the CCE, as well as their consequences on the portfolio of the bank's loans to the non-financial private sector. It concluded that the figures suggest that the adoption of the CCE has been important in mitigating the potential temporary effects on the evolution of the financial system's loan portfolio, while also allowing borrowers to cope with the temporary shock caused by the pandemic by maintaining their future access to loans.

In response to the pandemic, CNBV has introduced temporary adjustments to its regulations, including the Special Accounting Criteria (CCE), which allow for partial or total deferment of capital and interest payments for up to four months (with the possibility of extending this for an additional two months), opening the way for the balances of loans meeting these criteria to be frozen without interest. The initial deadline to sign up for the CCE was June 26, but this was extended to July 31.

With information to June, it can be seen that the approval rate for applications to join the program was 85.5%, with the business portfolio showing the lowest approval (59.2%) and the payroll portfolio having the highest approval (92.3%). Overall, loans covered by the CCE represented 18% of the bank's loan portfolio balance, with mortgage loans accounting for the highest percentage (26.6%).

It should be noted that most of the loans covered by the CCE have seen the continuance of the payments that would have had to have been made in the absence of the CCE and therefore these are classified as lower risk compared to those covered by the CCE which have seen an interruption in payments. Thus, through counterfactual exercises on the possible evolution of the portfolio, the report presents a possible impact on the delinquency of the non-revolving consumer loan portfolio with figures to June. The results of these exercises show that the possible impact on portfolio delinquency may be limited, and that the options offered to those borrowers who cannot continue to meet their payments will need to be monitored.

Monetary aggregates for a group of advanced and emerging economies registered a significant upturn from March

In its Quarterly Report for the second quarter of 2020, Banxico offers a comparison of recent developments in monetary aggregates and financing of the private sector in a selection of advanced economies (the US, Japan, the UK and the Eurozone countries) and emerging economies (Brazil, Chile, Colombia, Poland and Mexico). In this analysis, Banxico reports three common trends across the countries studied. First, there has been a very significant upturn in the more liquid monetary aggregates in these countries starting in March of this year. Second, we can also see a significant increase in bank loans to companies in most countries at the start of the pandemic. Lastly, there is a widespread contraction in consumer loans in all of the economies analyzed.

Indicators for the amount of money (in the broad sense) circulating in the economies of the selected countries show that, from March 2020, there was a significant acceleration in these countries, except for Chile. This acceleration is more moderate for the emerging economies than for the advanced economies. More specifically, the monetary aggregate M0 shows a very marked increase from March; i.e. it seems that the preference of households and businesses for cash accumulation remains despite the digital methods of payments available in the economy. In addition, demand deposits saw a significant upturn in several economies. According to the report, the accumulation of money in cash and liquid banking instruments in the countries analyzed has two main causes: precautionary reasons due to economic uncertainty and the inability to purchase goods and services from the heavily restricted sectors.

The analysis of private sector financing shows differentiated behavior between households and companies. From March, the expansion of loans to private non-financial companies accelerated and continued to the end of the second quarter. This was the case in most of the countries analyzed, except for Mexico, the United States and the United Kingdom, which in June showed signs of this acceleration beginning to reverse. By contrast, household loans showed a very significant slowdown across the board in all of the countries studied. The report indicates that mortgage loans from banks maintained moderate and stable growth in the economies studied, although in some countries it slowed down somewhat from May to date.

Housing prices rose by 5.8% in the second quarter of 2020

According to figures published by *Sociedad Hipotecaria Federal* (SHF) on August 10, the national housing price index increased by 5.8% in the second quarter compared to the same period last year. As mentioned in our January report, during 2020 we expected lower price increases in line with lower demand for housing, which will have been accentuated as a result of the COVID-19 pandemic crisis.

Our report from last month highlighted the contraction of more than 18% in the amount originated for mortgage loans in the first five months of the year, which also contributes to lower rates of price growth, due to lower demand. At the segment level, the price of low-income housing increased by 6%, while the middle-income segment increased by 5.6%.

In terms of metropolitan areas, from its report this month SHF included those from Tijuana, León and Querétaro, which recorded annual increases of 8.1%, 7% and 6.2%, respectively. The metropolitan areas of Guadalajara, Monterrey and Puebla-Tlaxcala also recorded gains of 8.1%, 6.8% and 7.1%, respectively, in the same period. Lastly, the metropolitan areas of Toluca and the Valley of Mexico recorded annual increases of 5.8% and 2.9%, respectively.

We estimate that, at the end of the year, the increase in the SHF index could be close to 5% at the national level, in cumulative figures. We therefore believe that, in combination with lower mortgage interest rates, the acquisition of real estate will be more affordable on the supply side.

2. Financial markets

Dollar weakness and a new boost to the risk appetite influenced by the FED

Risk asset prices accelerated growth during August. Even though the US Congress has failed to reach an agreement to extend tax breaks, recent changes in the FED's monetary policy framework and the dollar weakness have supported figures showing a moderate, but continuous, economic recovery in the major economies in favor of a continuing investor risk appetite.

The minutes of the last FED meeting and, most importantly, the adoption of a "flexible form of average inflation targeting," announced by the Chairman of the US central bank at the end of August at its annual meeting in Jackson Hole, translated into expectations among market participants of low rates for a longer period, a moderate increase in inflation expectations and a weaker dollar.

The scenario of negative real interest rates for a long period and a less costly dollar was reflected in increased demand for equity instruments. Both the global benchmark for this asset class (MSCI World) and the S&P500 posted their highest monthly growth for August since 1986, after obtaining yields of 6.6% and 7.8%, respectively. In the case of the emerging countries (MSCI EM), growth stood at 1.8%, while in the case of the Mexican index (IPyC) there was again a negative differentiation of approximately 0.8% in yield. It is important to note that the dollar's generalized depreciation encouraged the purchase of US shares, particularly those in the technology sector.

The moderate increase in inflation expectations in the US, resulting from the announced changes in the implementation of the US monetary policy, led to an upturn in longer-term yields and a steepening of the overall curve. The yield to maturity of the ten-year Treasury bond increased by 16 bp to close August at 0.7%, while the two-year Treasury bond barely increased by 1 bp, so the slope of the government curve was positioned at 57 bp at the end of August. In Mexico, yields on the long part of the curve also increased, influenced by the rise in US Treasury bonds and expectations of higher inflation in the short term. In particular, the yield to maturity of the 10-year Mbono closed August at 6.1%, 38 bp above the end of July, although it had reached 6.15% previous in the month. This rise was influenced by the fact that inflation in the first half of August was above expectations (3.99%) and by Banxico's upward revision of the average inflation forecast for the last quarter of the year (3.7%). It should be noted that in view of these increases in inflation and the split vote at the most recent meeting of the Banxico Governing Board, the IRS (Interest Rate Swap) curve discounts additional cuts of between 25 and 50 basis points in the monetary policy rate for the remainder of 2020.

In July, the dollar reached its two-year low against the developed currencies and it was close to returning to this level at the end of August. In fact, the dollar depreciated 0.9% against the developed currencies (DXY index) and 1.2% against the emerging-country currencies (JP Morgan EM Currency Index) during August. In this environment of a generalized dollar depreciation, the peso appreciated 0.6%, the tenth largest appreciation among the emerging-country currencies, leading to the exchange rate closing August at 21.9 MXN/USD. So far this year, the peso is still the sixth most depreciated currency with a fall of 13.5%.

On the commodity side, its global benchmark (S&P GSCI) grew by 6.1% during August, in line with signs of a recovery in demand in the global economy. The price of Brent oil rose 5.5% during that month, while the price increase was 10.6% for Mexican mixed crude, closing the month above USD 40 per barrel for the first time since March 5. For precious metals, the price of gold slowed its growth to 1.45% in August, which could be an indication of lower immediate risks perceived in the market and a slight upturn in interest rates.

Expectations that interest rates will remain close to zero for an even longer period have overshadowed the increase in COVID-19 cases around the world and the absence of further tax incentives in the US, to the extent that the narrative of rapid economic recovery remains the driving force behind many of the movements in the financial markets. Looking forward, and in addition to everything related to the pandemic, two main events with the potential to modify or reinforce this narrative can be identified. The first is the FED's monetary policy meeting in September. Given the importance of low interest rates to the narrative, investors will follow closely the FOMC's forward guidance and forecasts, particularly the implementation of recent changes to its long-term monetary policy framework. In addition, attention is increasingly focused on the US presidential election, especially if trends continue to indicate that we could again be facing a close voting.

3. Regulation

Adjustments to the regulation issued by Banco de México in response to the pandemic

On August 19, Banco de México issued Circulars 30/2020 and 31/2020 amending Circulars 20/2020 and 25/2020 concerning, respectively, the provision of resources to financial institutions to channel credit to MSMEs and individuals and the financing guaranteed by the bank's credit assets to be channeled to MSMEs. The adjustments, among other modifications, broaden the definition of MSME to include individuals carrying out business activities and also extend the deadlines for repurchase agreements and financing that entities arrange with Banco de México to obtain resources. Both circulars expand the use of the resources made available to entities so that, in addition to loans, they can be used for financial leasing and factoring. Circular 30/2020 also stipulates that resources can be used for payroll, personal, automotive and mortgage loans.

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