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Creating Opportunities

Banking

Monthly Report on Banking and the Financial System

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November 3, 2020

1. Banking and the financial system

For the first time in ten years, bank credit to the private sector fell in real terms.

In August 2020, the balance of existing credit granted by commercial banks to the non-financial private sector grew at a nominal annual rate of 2.7% (-1.3% in real terms), which was lower than the nominal rate recorded in the previous month (4.9%) and the nominal rate of 8.9% recorded in the same month in 2019, thus representing a contraction in real terms for the first time in 10 years (a contraction of -0.7% was recorded in July 2010). This result shows that the slowdown in the three segments comprising the aggregated credit to the non-financial private sector was synchronized, as the consumer and business loan portfolios continued to become less dynamic, and only the mortgage loan balance maintained positive real annual change. In August, the contribution of 2.7 percentage points (pp) made by the three segments to total bank credit was as follows: business loans contributed 2.4 pp and mortgage loans 1.6 pp; while consumer loans subtracted 1.3 pp.

Weak revenue from sales of goods and services, coupled with deteriorating investment conditions, negatively affected companies' demand for bank financing, meaning that one of the main drivers of credit for the private sector was lost. Consumer loans entered a sharp slowdown stemming from the effect of job losses, which will reduce both the potential customer base and households' repayment ability. The segment showing less severe deterioration, partly because its performance in terms of economic activity and formal employment is delayed, is mortgage loans, which is already showing a clear slowdown, albeit a more gradual one. The unfavorable outlook for a rapid recovery in employment and investment means that growth expectations for private sector credit remain low in the short term.

Traditional deposits show a rapid slowdown

During August, traditional deposits (demand + term) in the banking system fell at a faster monthly rate as a result of a further fall in deposits of the term segment and the reduction (for the first time in the last six months) of demand deposits by individuals. The magnitude of the monthly decline in traditional deposits was alleviated by unexpected monthly growth in demand deposits by companies, which could be linked to an incipient rebound in economic activity following the opening of the economy and the increase in the issuance of corporate securities.

Similar to recent months, the contrast between a continuous reduction in traditional deposits in the short term (monthly growth rates) and a slowdown in this variable in the medium term (year-on-year growth rates) was observed. Specifically, traditional deposits fell by 0.6% in nominal terms (-1.0% in real terms) between July and August due to a 1.9% nominal monthly fall (-2.3% in real terms) in the term segment and marginal growth at a monthly nominal rate of

0.2% (-0.2% in real terms) of demand deposits. Compared to August 2019, traditional deposits grew by 10.1% in nominal terms (5.8% in real terms), a fall of almost 3.0 percentage points (pp) compared to the annual rate recorded in July. By segment, annual growth of term deposits in nominal terms was barely 2.5% (-1.5% in real terms) in August, a drop of 3.0 pp from July and of 8.5 pp compared to the annual rate recorded in April 2020, while annual growth in the demand deposits segment slowed to 15.4% in nominal terms (10.9% in real terms) in August, down from the annual nominal rate of 18.1% recorded in July.

As the months go by, deposits in the banking system are growing increasingly reflective of the effects of the economic downturn, following the unusual increases recorded during the first months of the pandemic. In general, term savings are continuing to decrease owing to the fall in employment and income, coupled with low interest rates; while the fact that individuals reduced their more liquid balances in August, leads us to predict that the downward trend in demand deposits could worsen in the future.

The balance of risks for the Mexican financial system is deteriorating as a result of the COVID-19 pandemic

At the end of September, the Financial System Stability Council (CESF by its Spanish acronym) published its annual activity report. Unlike previous editions, the publication of this report was delayed by almost half a year and, as such, the reporting period on this occasion runs from April 1, 2019 to September 30, 2020. During this period, the deterioration of the balance of risks for the Mexican financial system as a result of the COVID-19 pandemic was notable.

The report presents stress test results for various financial intermediaries. With regard to commercial banking as a whole, the sector has reasonable liquidity levels and a capitalization profile able to cope with stressed macroeconomic conditions. However, risks persist that could intensify and affect the functioning of the sector. The main response from commercial banks to negative shocks in the simulated macroeconomic variables during the year can be seen in the contraction of credit portfolio growth estimates and the reduction in the amount of dividends paid. In particular, a lower Capitalization Index (ICAP) was estimated in the adverse scenario than in the baseline scenario as a result of weaker growth in the loan portfolio, leading to a contraction in revenue and to higher expenditure in the constitution of provisions, resulting in a decrease in the profits generated. Capital shortages were identified during this simulation for six institutions which, together, account for 0.6% of the system's assets. The CESF believes that problems with exposure to sectors or segments experiencing a greater impact on their income cannot be ruled out; moreover, some institutions face specific challenges relating to concentration in their funding sources.

In addition to the stress testing carried out for commercial banks, the report presents a sensitivity exercise to measure the impact of the pandemic on the loan portfolio. In the adverse scenario, it is assumed that restrictions to contain the pandemic will be reduced more slowly, which is reflected by a slower economic recovery, and that there will be episodes of volatility leading to falls in stock indices and currency depreciation. Furthermore, reduced oil prices in Mexico is causing a deterioration in Pemex's financial situation, leading to greater investment portfolio adjustments and capital outflows. Based on this scenario, the expected losses by portfolio type were estimated for each banking institution, and impacts on the ICAP were forecast up to December 2022 (taking data as at the end of June 2020 as the starting point). Based on the estimate of these expected losses, the amount of additional loan loss provisions and the respective impact on the ICAP were determined for each banking institution.

This exercise found that approximately 55% of the increase in loan loss provisions is associated with the consumer portfolio, 9% with the mortgage portfolio, 20% with the corporate sector and 11% with the SME sector. Moreover, a fall of 179 basis points is estimated in the capitalization index. It should be noted that the most severe forecasts are for the first half of 2021. In both March and June 2021, three entities would record an ICAP of below 10.5%, with said entities representing 0.3% of the assets of commercial banking institutions.

With regard to the stress tests for other financial intermediaries, the report highlights that for intermediaries in the retirement savings sector,and in the insurance and bonds sector, the effects of the pandemic have remained limited. As for the stock market sector, the report identifies that stock exchanges continue to maintain capitalization and liquidity levels above the regulatory minimums, while investment funds have not seen significant sector-wide redemptions. Finally, Popular Finance Companies (Sofipos by its Spanish acronym) and Credit Unions proved to be the most vulnerable financial institutions based on the current trajectory, as they have a higher credit risk profile than other intermediaries due to the market segment to which their services are oriented.

18.5% of the total commercial banking loan portfolio was covered by the CCE

As part of its annual report, the CESF presented an analysis on the implementation of the Special Accounting Criteria (CCE by its Spanish acronym). These criteria were a temporary measure issued by the National Banking and Securities Commission (CNBV) on March 27, 2020; and the benefit of which was that loans (consumer, housing and commercial) covered by the CCE would not be treated like an expired portfolio. This measure allowed financial institutions to offer a grace period (four months with the possibility of increasing this by a further two months) in the repayment of capital and interest. This benefit was applicable to loans classified, in accounting terms, as current as at the end of March 2020 (originally as at February 28).

According to the report, 18.5% of the total commercial banking loan portfolio (commercial, housing, consumer) was covered by the CCE as of June 2020. When broken down, around 13% of the commercial portfolio was covered by the CCE, with the portfolio of the Hotels and Restaurants sector seeing the largest restructuring (47%), followed by Communal and Social Services (33%). In the housing portfolio, the percentage covered by the CCE was more than 30%, with Mexico City and Nuevo León having the largest share of restructured loans covered by the CCE, reporting 10.9% and 10.3% respectively. In terms of the consumer portfolio, 24.1% was covered by the CCE, with BBVA, Citibanamex, Banorte, Santander, HSBC and Scotiabank accounting for more than 90% of the restructuring.

The report highlights that the implementation of the CCE helped to maintain asset quality indicators. In June 2020, the non-performing loans ratio of the commercial, consumer and housing portfolios not covered by the CCE was 1.4%, 5.8% and 4.7%, respectively, but when the portfolio covered by the CCE was included, the IMOR of the commercial portfolio was 1.2%, with the consumer portfolio at 4.4% and the housing portfolio at 3.1%. The expected loss (the ratio between preventive estimates and the outstanding balance of qualified loans) of loans not restructured using the CCE was 4.0%, which, together with the expected loss of those covered by CCE (1.5%), puts the indicator at 3.5% for the total portfolio. Finally, the document emphasizes that it will be important to monitor defaults as the grace period ends, and the rebound in asset quality indicators can be quantified.

Mortgage interest rates at historically low levels

The weighted average interest rate for commercial banking mortgage loans stood at 9.73% in annual terms in August 2020. This is the lowest mortgage rate recorded in more than three years, namely since February 2017, when it stood at 9.71%.

The sharp decline in the cost of funding to buy a house is aligned with monetary policy decisions, which, in response to the crisis caused by the COVID-19 pandemic, continue to aim at incentivizing consumption. As previously mentioned on other occasions, the characteristics of the mortgage market in Mexico (fixed rates and average liquidation terms of between eight and ten years), are limiting the transmission of short-term interest rates to this market, with the long-term rates—in particular the ten-year bond (M10)—being those that determine mortgage rate behavior.

As such, the fact that mortgage rates are at historically low levels is explained even by the downward cycle observed over the course of 2019 with respect to the M10, which fell from 8.4% in January to 6.8% in December. Measures were further relaxed once the pandemic started, and it fell from 6.6% in January 2020 to 6.0% in August 2020. This is a reduction of 55 basis points (bp).

Given the lag effect in terms of monetary transmission between the M10 and the mortgage market, we expect the downward cycle to continue, and the mortgage rate could even be below 8.0% throughout 2021. This situation will be attractive when acquiring a mortgage loan, as competition will increase between banks in terms of offering the best rates.

2. Financial markets

A surge in coronavirus cases leads to a new widespread episode of risk aversion in the face of the US presidential election.

The last week of October demonstrated the vulnerability of risk asset valuations to the uncertainty that is negatively impacting the global economy. The significant increase in cases and levels of hospitalization due to coronavirus in the US and Europe has already resulted in another round of partial lockdown measures in much of the old continent, which suggests an acceptance that testing, tracing and selective lockdown protocols have proved inadequate. This was the main catalyst for a risk aversion episode arising from concerns among market participants that recovery would be set back, which calls into question the assumption of a rapid economic turnaround that has underpinned recent market dynamics.

It is important to note that the risk aversion episode in the last week of October was widespread, i.e. there was no clear trend toward safe haven, but losses were recorded across virtually the entire range of asset classes. This seems to validate the analysis of the IMF, which, in its most recent Global Financial Stability Report, highlights the historically high level of annual correlation between various asset classes (0.8) since the pandemic began and the adverse consequences on portfolio diversification and the risk of transmission that this could have.

For stock markets, the aforementioned risk aversion episode meant that, in several cases, not only did they lose earnings accumulated during the first part of October, but they also had their worst weekly performance since March. North American markets performed marginally better than the global benchmark for this asset class (MSCI World Index), which fell 5.7% between October 23 and 30, and -3.1% over the course of the whole month. In particular, the S&P 500 and Nasdaq fell 5.6% and 5.5%, respectively, during the last week of October, and they recorded losses of 2.8% and 2.3% respectively over the course of the whole month. Conversely, emerging markets (MSCI EM index) performed positively as, despite a 2.9% decline between October 23 and October 30, they managed to maintain growth of 2.0% by the end of the month. The Mexican Stock Exchange Index of Prices and Quotations (IPyC) closed October with a 1.3% drop.

In the fixed income market, the 10-year Treasury bond yield increased by 3.0 basis points (bp) in the last week of October, despite the sale of risky assets. Thus, the yield of this node closed October at 0.9%, an increase of 19 bp compared to September. In the short part of the curve (2Y), the yield increased just 3 bp during the month, with the slope increasing by 26 bp in October. This increase is consistent with expectations that a Democratic victory in the US presidential election next Tuesday would result in higher fiscal expenditure. In Mexico, the Mbono 10-year bond yield increased by 9 bp during the last week of October, as a result of the sale of assets with a higher level of risk, in line with a 6.0 bp rise in sovereign risk (CDS spread). The Mbono 10-year bond yield increased by 17.0 bp in October, influenced, in addition to the global environment, by higher-than-expected inflation data, which is keeping annual CPI growth above 4.0%.

Performance was similar in the commodity market. Losses of 5.0% were recorded in the benchmark for this asset class (S&P GSCI Index) between October 23 and 30, resulting in losses of 2.7% over the course of the whole month, following growth of 32.6% over the past 6 months. As expected, the new partial lockdown measures generated expectations of lower oil demand, reflected in falls in the prices of Brent and the Mexican Mix during the last week of October of 10.3% and 11.5%, respectively. At the close of October, Brent stood at USD 37.5 per barrel and the Mexican Mix stood at USD 32.6 per barrel, a level that has not been recorded since mid-June. As another example of the widespread sale of assets during the last week of October, gold fell 1.2%, which was enough to result in its second consecutive month of decline.

In the foreign exchange market, the dollar benefited the most, with 1.4% and 1.5% increases during the last week of October compared to developed and emerging currencies, respectively. The Mexican peso depreciated 1.5% during this period, but managed to maintain an appreciation of 4.2% for the whole of October, making it the most appreciated currency among emerging markets during that month. In fact, the exchange rate hit a six-month low of 20.86 ppd (pesos per dollar) once again on October 23, but failed to remain below 21.0 ppd, closing the month at 21.2 ppd. Even with this appreciation, implied exchange-rate volatility is above 20.0%, which is adversely affecting the dollar yield of fixed-rate government bonds. This continues to be reflected in reduced foreign ownership of such assets.

Recent IMF and BIS reports confirm the idea that current valuations of risk assets are being supported by expectations that interest rates will be low for a prolonged amount of time, and that there will be high liquidity resulting from asset purchases by central banks at a global level. As such, and in light of the second wave of coronavirus infections in Europe and an accelerated rate of transmission in the US, in the coming weeks markets will focus on central bank communication, but particularly on further government decisions regarding financial support with the aim of ensuring that the economic recovery will not be delayed. It is in this context that the US presidential election gains even more significance because, depending on the speed and clarity of the outcome, as well as the smooth operation of its institutions, it has the potential to become a firewall or a catalyst for a period of higher volatility.

3. Regulation

Adjustments to CNBV Regulatory Facilities

On October 8, the CNBV made adjustments to the regulatory facilities established as recently as September 24 through which the regulator is seeking to encourage the restructuring of loans affected by COVID-19.

Of the amendments, among other aspects, the following is notable: The criteria required to ensure that the restructures are beneficial in terms of releasing provisions and acknowledging said provisions in regulatory capital have been relaxed. Conversely, dividends for the financial years 2019 and 2020 may be distributed, albeit subject to strict requirements. Furthermore, the eligibility of loans for said restructures has been expanded to include those whose repayment would have been affected by the pandemic up to January 31, 2021, rather than September 24, 2020 as originally provided for, while the maximum time limit for formalizing restructures under the Facility has been brought forward to January 31, 2021 (previously September 24, 2021).