Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Growth in credit to the non-financial private sector (NFPS) slows further in October 2020

The nominal annual growth rate of bank credit to the non-financial private sector (NFPS) stood at 1.7% (real: -2.3%) in October 2020, less than one-third the rate recorded in the same month of 2019 (5.8%) and also below the nominal annual rate of 2.5% registered in the previous month. This ten-month figure indicates that the slowdown in the growth of private sector credit since April 2020 has worsened. April was the last month this year when double-digit nominal growth was posted, while October is the third consecutive month with a negative real annual change. The nominal growth rate for October comprised 1.6 percentage points (pp) of business loan growth and 1.7pp of mortgage loan growth, which were partially offset by the 1.6pp reduction in consumer loans.

During the tenth month of the year, business credit grew at a nominal annual rate of 2.8% (equivalent to a real annual change of -1.2%). This result sees the rate of growth of outstanding credit to companies having slowed six months in a row. This weak performance reflects both the fall in sales revenue and the prolonged contraction in investment. In the first case, although the slump in revenue from the supply of goods and services is less pronounced compared to the low recorded in May, revenue is still shrinking year on year. In October, this type of revenue fell by 6.6% for wholesale trade, 7.7% for retail trade and 17.2% for the services sector. This decline in revenue diminishes firms' ability to pay and could discourage them from assuming payment commitments in the short and medium term (such as credit) in the face of uncertainty about the speed at which their revenue will pick up. In addition, demand for financing by companies has been limited by the absence of attractive investment conditions, which has been reflected in the gross capital formation indicator. In September (last available figure), this indicator contracted 18.0% (seasonally adjusted figures), accumulating 20 months of consecutive falls.

There was a 7.3% cumulative annual decline in consumer loans in October, higher than in the previous month (-6.4%) and well below the 6.2% growth rate observed in October 2019. With the October 2020 result, the nominal growth rate of the outstanding loan book in this segment has been shrinking over the last six months, reflecting the weak performance of private consumption. In particular, the monthly indicator of consumption in the internal market published by INEGI, contracted in September (last available figure) by 11.4% (seasonally adjusted figures). Consequently, the annual rate has been falling for ten months in a row. A drop in employment and resulting decline in household income, as well as greater caution about the future performance of the economy, could explain this sharp slowdown in consumption and demand for money to finance it.

Lastly, the nominal annual growth rate of mortgage loans was 8.9% in October 2020, almost equal to the growth of the previous month and less than the 10.7% reported in the same month in 2019. Although the outstanding mortgage loan

balance has been growing more slowly, it has done so at a slower pace than consumer lending. This is due in part to the fact that the bulk of job losses have been in lower-wage segments, and most bank credit for housing is in the middle-income residential segment. There also tends to be a lag between changes in formal employment and the effect thereof on this portfolio, so the loss of higher-wage jobs and the negative impact on income will take longer to affect the growth of this portfolio.

Preference for liquidity continues: growth in demand deposits hits all-time high

In October 2020, the nominal annual growth rate of traditional deposits (demand + term) was 12.8% (real: 8.4%), which sees the eight consecutive month of double-digit growth. The October result was higher than the previous month (12.2%) and almost three times that of the same month in 2019 (when nominal growth was 4.4%). The vigor seen since the start of the public health crisis last March reflects both a higher preference for liquidity (mainly for precautionary purposes) and the slowdown in consumption that has favored the accumulation of immediately callable deposits. In particular, demand deposits contributed 12.0pp to the nominal annual growth in traditional deposits, while term deposits contributed 0.8pp. Meanwhile, growth in debt funds continued to wane, with a nominal growth rate of 2.5% (-1.6%): the lowest observed since October 2017. With this result, growth in debt funds has been slowing for nine months running, which echoes the negative impact of greater uncertainty and agents' preference for more liquid savings alternatives.

A nominal growth rate in demand deposits of 20.2% (real: 15.5%) was posted in October, which is an historic high. This dynamism mainly stemmed from balances held by natural persons, which grew at a nominal growth rate of 24.9% in October, while the balances of companies increased by 18.5% (combined, the two segments account for 82.2% of total demand deposits). Agents have been encouraged to invest in demand deposits due to the lower interest rates and the need to hold cash balances as a precautionary motive.

On the other hand, term deposits recorded a nominal annual growth rate of 2.0% (real: -2.0%). In this case, the balance held by both natural persons, the non-financial public sector and other financial intermediaries (other than banks) in term deposits has been falling over the six-month period, which is mainly associated with the decline in interest rates (between March and October, the average interest rate for this type of deposit fell from 6.4% to 4.1%). Only the balance of term deposits held by businesses (34.7% of the total) has continued to expand, with nominal growth of 30.7% in October. This brings eight consecutive months of double-digit growth, which remains at an all-time high. This accumulation of cash could be associated with both the accumulation of funds from unused lines of credit, and an increase in fixed term savings in the absence of any incentives or opportunities to invest.

Risk of a weak economic recovery and increased volatility in financial markets remains

Mexico's Financial System Stability Council (CESF) updated its balance of risks in December. The CESF communique stresses that the economic recovery has not been uniform across countries and sectors, and uncertainty remains about the pace of recovery in the future. The full impact of the pandemic on the economy remains to be seen and certain risks could intensify, affecting the functioning of Mexico's financial system. In particular, the effects on the loan portfolio in the most vulnerable sectors are still uncertain, and some financial institutions still face specific vulnerabilities

associated with the concentration of their sources of financing. The risk of a slower recovery of the national economy, a potential rechanneling of international flows to lower-risk assets, and possible adjustments to the sovereign and Pemex ratings also remains.

CESF also took the results of the Systemic Risk Perception Survey to analyze changes in the perception of major financial risks. It found that the perception of credit and funding risk for financial institutions remains significantly higher than before the pandemic, although slightly lower than those observed in the previous half year.

Lastly, the communique highlights the importance of analyzing the problem raised by the draft decree amending Mexico's Bank Law with regard to the acquisition of foreign currencies. It underlines the readiness of Mexico's central bank to work with the Congress of the Union to build a legal framework that benefits those who legitimately receive currencies in cash.

Banco de México (Banxico) publishes Financial Stability Report for second half of 2020 (2H20)

This report provides the central bank's six-monthly findings on the main risks and vulnerabilities that could affect the stability of the Mexican financial system. This update highlights that the financial system has stood firm in the face of adverse shocks generated by the pandemic and has maintained high capital levels and decent liquidity. Nevertheless, there is still uncertainty about the magnitude of the pandemic's impact on the loan portfolio in the most vulnerable sectors. The central bank's stress tests indicate that, as a whole, the banking sector has an adequate level of capitalization and liquidity. However, in certain scenarios, some institutions would not reach the minimum regulatory capital requirements.

Banxico notes that, in future, it will be of particular importance to follow the loan quality indicators of the various intermediaries, both because of the consequences that higher delinquency could have for households' future access to credit, and because of the risks financial institutions might face. Moreover, the central bank suggests that a more active involvement of development banking would be desirable in order to preserve and reactivate lending, since this could be a countercyclical tool that mitigates the effects of the economic downturn. It also stresses the need to boost the confidence of investors to attract capital flows by providing a sound macroeconomic framework that offers certainty and facilitates access to credit for different sectors of the economy.

Total financial savings increased by 8.0% year on year in real terms during the second quarter of 2020, while total financing expanded at a rate of 5.5%

The National Banking and Securities Commission (CNBV) has published its report on Financial Savings and Financing in Mexico with information as of June 2020 (2Q20). Over that period, there was an 8.0% real annual increase in total financial savings –defined as the aggregate balance of deposits of financial intermediaries, the holding of fixed income securities and trust stock certificates, and the foreign funds intermediated through the Mexican financial system– to an equivalent of 127.7% of GDP.

The domestic component of financial savings showed real annual growth of 7.3% and was equivalent to 89.7% of GDP. At a more detailed level, deposits of financial intermediaries (banks, SOCAPs [*Sociedades Cooperativas de*

Ahorro y Préstamo – savings and loans cooperatives], SOFIPOs [*Sociedades Financieras Populares* – popular finance companies], credit unions and development agencies and bodies) registered a real annual change of 7.9% in June 2020 to an equivalent of 44.7% of GDP. Most of the funds obtained in 2Q20 are concentrated within commercial banks (29.3% of GDP), followed by Infonavit (*Instituto del Fondo Nacional para la Vivienda de los Trabajadores* – Mexican federal institute for worker's housing) (6.4% of GDP) and development banking (4.4% of GDP).

Foreign savings, meanwhile, showed real annual growth of 9.7% and represented 38.0% of GDP in 2Q20. Foreign savings received by the public sector amounted to 24.7% of GDP and that received by the private sector to 13.3%. The balance consisted of securities issued in Mexico held by non-residents (10.6% of GDP), securities issued abroad (17.7% of GDP) and loans obtained abroad (9.7% of GDP).

As for total financing, defined as the aggregate balance of the loan portfolio granted by Mexican-resident financial intermediaries to the private and public sectors, the outstanding debt in the domestic securities market, and foreign funds received in 2Q20 expanded at a real annual growth rate of 5.5%, equivalent to 127.0% of GDP.

Domestic financing showed a real annual change of 2.1% and represented 99.6% of GDP in 2Q20. Domestic financing to the private sector equated to 47.4% of GDP. The main source of domestic financing in the private sector was credit from commercial banks (24.5% of GDP), while in the public sector the main source of domestic financing was from the placement of securities (48.0% of GDP).

In terms of foreign financing (of the private and public sectors) in 2Q20, this reached 27.4% of GDP and showed a real annual increase of 20.2%. Between June 2019 and June 2020, the balance of foreign financing to the private sector grew at a real annual rate of 20.5% and reached the equivalent of 12.8% of GDP, while foreign financing to the public sector rose by 19.9%, accounting for 14.6% of GDP.

2. Real estate sector

Value of construction output fell by 20% in 2020

According to data from INEGI's Monthly Survey of Construction Enterprises (ENEC), the value of construction output declined 21.02% in annualized terms as of November 2020.

The value of housing output, which represented 43% of the total, decreased by 18.8% in real terms, annualized as of November 2020. However, productive (i.e. commercial and industrial) construction (47.6% of the total) contracted by 21.6% over the same period, also in real terms. As a result of the crisis caused by the Covid-19 pandemic, all building components remained in negative territory; this, despite a cycle of falling short- and long-term interest rates. The reference rate, which immediately determines the cost of bridge loans, closed the year at 4.25% and is expected to reach 3.5% in May this year. Meanwhile, although they might have reached a low in December 2020, mortgage rates will remain below pre-crisis levels, when they topped 10% per annum.

In light of the above, we expect productive construction to rebound more quickly than the housing market. This would be explained by a recovery in exports and investment, as a result of the entry into force of the T-MEC, which would first

reignite demand for credit to build commercial and services properties. We envisage this occurring during the first half of 2021.

3. Financial markets

Another month of gains for risk assets as the markets expect the pandemic will be brought under control early in 2021. Exchange rate closed 2020 below 20 pesos per dollar (ppd)

The last month of 2020 closed with high returns on risk assets off the back of greater expectations that the pandemic would be brought under control within the next six months and that the global economy would gather steam once more. The rally that began in the first half of November after the Pfizer vaccine proved effective continued through December, as vaccination campaigns began in the U.S. and a new round of fiscal stimuli was launched. All this came as a second wave of the Covid-19 pandemic hit, which has resulted in record numbers of infections, hospitalizations and deaths in several countries. The principle of asset valuation appears to explain the conundrum between the public health crisis and price performance in the financial markets. This principle establishes that the price of an asset can be defined as the present value of its future cash flows. According to current assumptions, the costs associated with the pandemic are only expected to continue for the next few months, while positive cash flows (supported expectations of more fiscal support) and, above all, low interest rates (the discount factor) are expected to continue for a long time.

With hopes that the pandemic will be quashed in 2021, stock markets continued to favor cyclical stocks, even though gains were posted virtually across the board, as the December 4.1% rise in the MSCI ACWI global benchmark for this asset class shows. US markets posted different gains over the last month of the year. The S&P500 and Nasdaq climbed 3.7% and 5.6%, respectively The Russell 2000, which includes medium- and low-cap companies, gained 8.5%, supporting the idea of cyclical rotation. The Emerging Markets Index (MSCI EM) also stood out, climbing 7.15% in the last month of 2020. For the Mexican Stock Index, the 5.5% gain in December meant not only its second consecutive month on the rise, but also the increase needed to end up with a gain of 1.2% over the whole of 2020.

In the fixed income market, the hope of an economic recovery fueled by more public spending by the next U.S. administration led to an increase in yields at the long end of the curve. In fact, the yield to maturity (YTM) of the 10-year Treasury bond rose by 7.0 basis points (bp), taking the YTM of this maturity to 0.9% at year end. This represented a drop of 100bp with respect to the end of 2019. At the short end of the curve (2Y) the yield increased only 3bp in December. This increased the slope to 79bp in October, its highest level in 2020. In Mexico, the YTM of the 10-year bond fell 25bp in December, influenced by the reduction in inflation and a fall of 6.4bp in sovereign risk (CDS spread) in the same month. Thus, the YTM of the 10-year bond closed 2020 at 5.5%, 136bp below that recorded at the end of 2019. Meanwhile, despite the Mexican economy shrinking by around 9.0%, sovereign risk, measured by the 5-year CDS spread, closed 2020 at 81.5bp, almost the same level as at the end of 2019.

In the commodities market, the December 6.2% hike was not enough to reverse the year's losses, as the benchmark for this asset class (the SPGSCI Index) closed with a 6.1% drop in 2020. Similar behavior was observed in the oil market. At the end of December, Brent and the Mexican Mix traded at USD 51.8 per barrel and USD 47.2 per barrel, respectively; below the 2019 year-end levels of USD 66 and USD 56 per barrel, respectively. Gold, on the other hand,

was one of the most profitable assets in the year (24.4%) influenced by the scenario of low interest rates and the risk aversion episodes.

Turning to the currency market, the weakness of the dollar prevailed in December, dropping by 2.1% and 2.8% against the currencies of developed and emerging countries, respectively. The Mexican peso appreciated 1.3% in December, leading to a 19.9ppd exchange rate level at the end of the year. This represented a drop of 5.2% compared to the end of 2019. Undoubtedly, the weakness of the dollar, lower risk aversion and the search for yield, as interest rates are expected to remain low for a long time, are the main factors behind this significant appreciation of the peso. Despite this appreciation, implied exchange-rate volatility hit 15.2% at year-end, which is adversely affecting the dollar yield of fixed-rate government bonds. This was reflected during 2020 in a continuing reduction in foreign holdings in peso-denominated bonds, which clearly constitutes a risk factor for financing the Mexican economy.

The assumptions underlying risk asset valuations remain quite optimistic, especially given the uncertainty that, one year later, remains about how the pandemic will evolve. Countries will have to overcome various unanticipated challenges regarding production and distribution of vaccines among their populations before consumption is to rebound. Low discount rates are a given; we will have to wait for flows to materialize as early in 2021 as the market assumes.

4. Regulation

CNBV: changes to acceptance of *in rem* guarantees

On December 4, the National Banking and Securities Commission (CNBV) amended the Single Banking Circular requiring credit institutions to introduce internal methods and controls that ensure the *in rem* guarantees they receive from their borrowers are not securities issued by the same common risk group to which these borrowers belong.

Banxico: an end to some interim pandemic regulatory exemptions

On December 29, the Bank of Mexico issued Circular 44/2020 "Provisional exemptions in relation to the Covid-19 pandemic" amending circulars 12/2020 and 8/2020 and that cancels the introduced exemptions and resumes the calculation of the time limits for the filing, processing and resolution of appeals for reconsideration and review, and for the imposition of penalties, respectively.

Cofece considers lack of competition in the payment card market

On December 16, an extract from the opinion of the Federal Economic Competition Commission (Cofece) on the Card Payment Network (CPN) market, the processing of which involves a clearing house, was published in Mexico's Official Federal Gazette (DOF). In it, the Commission concludes that there are no conditions for effective competition in the market due to the likely existence of four barriers to competition and free access.

Cofece has proposed a number of recommendations to the CNBV and Banxico including: (i) issuing a regulation that allows acquirers to determine the rules for Domestic Transactions involving two or more CPNs, guaranteeing the differentiation of services and facilitating acceptance of cards; (ii) amending the regulation to allow each CPN to register and adopt the method it considers to formulate its own interchange fees; (iii) analyzing the suitability of E-Global and Prosa and their members operating with their own interchange rules and fees; and (iv) lifting the obligation of Brand Holders to ensure the daily liquidity of transactions and, instead, impose an obligation that each clearing house guarantee the transactions it processes.

Cofece also requested that Banxico: issue the necessary regulation to establish the requirements for the linking of inter-clearing house processing systems; remove link certification by incumbents; issue guidelines for link requirements; set maximum times for incumbents to link; and issue penalties.

Finally, Cofece ordered E-Global and Prosa to implement severe corrective measures, most notably the floating of 51% of their voting shares; their transformation into publicly listed companies; and the prohibition barring their management personnel from working or providing services as directors or decision-makers of any issuer, acquirer or clearing house. They should also request authorization from Cofece for any subsequent act involving the acquisition of 10% or more of their shares.

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