Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Downward trend in consumer and business lending continued during the first month of the year

In January 2021, the balance of outstanding loans granted by commercial banking to the non-financial private sector once again registered an annual decline in nominal terms of 1.3% (-4.6% real), practically the same as the December figure (-1.2%). This decline was below the 2.0% growth observed in January 2020. The nominal monthly change from December was only -0.2%, significantly lower than the average 1.2% reduction in the last eight months (when the private sector credit balance began to shrink). The downward trend in consumer and business lending continued, with nominal contractions in January, while the volume of mortgage loans remained stable with a nominal rate of around 8.5%.

At the beginning of the year, the decline in business lending became widespread in both domestic currency and foreign currency denominated balances. In addition, a slowdown in lending to small enterprises, large businesses and trusts is now apparent. This illustrates that the deterioration in the business environment has spread to more companies. Weak demand for goods and services, as well as a lack of favorable conditions for initiating medium- and long-term investment projects will limit the need for enterprises to acquire new financing.

The trend in lending to households continues to be mixed. In the case of consumer loans, the volume of lending reflected the deterioration in the indicators of private consumption and formal employment. Consumption will be slower to rebound as some restrictions on certain activities may be reimposed due to spikes in infections and/or a slow rollout of vaccines, which would see this loan portfolio taking longer to recover. On the other hand, the mortgage portfolio is still not fully reflecting the decrease in formal job generation. Prevailing low interest rates and the relative heightened attractiveness of investing in real estate over other types of assets have resulted in the growth rate of this portfolio remaining stable. However, as with the rest of private sector credit, a slowdown is expected in the future.

Double-digit annual growth in bank deposits extended into January

During January, the balance of traditional bank deposits (sight + term) fell 0.5% in nominal terms (-1.4% real) compared to last December–the largest monthly decline since January 2020. With the exception of non-financial public sector deposits, the remaining components of traditional deposits registered negative monthly growth rates. In fact, according to data from Bank of Mexico (Banxico), the balance of sight deposits (65% of traditional deposits) shrank 0.8% month-on-month in nominal terms (-1.6% real), its first decline since last May; while the balance of term deposits (35% of traditional deposits) remained unchanged (-0.9% real).

In annual terms, the notable increase in deposits for precautionary reasons, associated with the pandemic, continued with double-digit growth rates. Growth of traditional deposits sped up from an annual nominal rate of 10.1% (6.7% real) in December 2020 to 11.2% (7.4% real) in January 2021. This was fueled by nominal annual growth of 19.5% (15.5% real) of sight deposits despite the 1.4% annual nominal decline in term deposits (-4.8% real) during the first month of the year.

It is important to note that a significant drop in these growth rates is expected in March because of a base effect, which will contrast with the high level of new deposits when the pandemic hit.

Seasonal factors lie behind the dynamics of the monthly reduction in deposits. The need for clients to settle outstanding bills at year-end, as well as increases in prices and taxes, made January a weak month in terms of bank deposits. This year was no exception. Nevertheless, aside from these seasonal fluctuations, the decent figures for deposits by individuals and on-going low levels of fixed term saving continue.

Moving forward, job figures and progress with the vaccination program will be crucial to how bank deposits change. This is especially relevant with regard to the movements of the large volume of liquid balances individuals keep in the system.

Shift from external sources of financing to internal ones persisted in the fourth quarter of 2020

The Bank of Mexico has published its Quarterly Report with data from the last quarter of 2020 (4Q20). The document includes a review of lending conditions in the economy and the stability of the financial system. The report highlights that the level of financial resources in the economy remained high in 4Q20 with real growth of 4.5% (adjusted for exchange rate and asset price fluctuations). This was driven by an increase in internal sources of financing (8.3% real) off the back of higher precautionary saving and a preference for liquidity among households and businesses alike. External sources, on the other hand, shrank in real terms by 2.4%. Most of the increase in funding was channeled into the public sector, which registered a real annual increase of 4.6%, while private sector financing contracted for the third consecutive quarter by 1.8%.

With regard to the stability of the financial system, the report stressed that, as a whole, the banking system has withstood the shocks associated with the pandemic thanks to its high levels of capital and liquidity, although uncertainty prevails over the future performance of the loan portfolio for the sectors most exposed to the effects of the pandemic. In the last quarter of the year, the banking sector's capitalization index (ICAP) was 17.7%, higher than in the previous quarter. This increase reflected the growth in net capital due to both profit retention and capital contributions. In addition, there was also a decrease in risk-weighted assets, which partly reflected lower levels of non-financial private sector credit.

In turn, credit risk in the banking sector rose in the last quarter of 2020 associated with higher non-performing loan ratios in the consumer, home and business loan portfolios, and increases in the probability of default in the consumer and home loan portfolios. The delinquency rates of the three portfolios mentioned beforehand were up on the previous quarter. Market risk, meanwhile, decreased from 3.77% in September to 3.57% in December. This stemmed from an increase in government bond exposure in the banking portfolio.

In 4Q20, there was also a real-term contraction of 1.5% in financing granted to the non-financial private sector by other (non-banking) intermediaries. The quality of the portfolio of these intermediaries remained stable. With regard to the risks associated with non-financial private companies listed on the Mexican Stock Exchange, the report highlighted that their debt indicators and capacity to repay their debt improved over the previous quarter thanks to higher operating cash flows and lower debts.

Having an income of over 5,300 pesos is one of the most significant factors that increases the likelihood of saving in Mexico

The National Banking and Securities Commission (CNBV) has published the report *El Ahorro en México: Productos, Instrumentos y Evolución* (Savings in Mexico: Products, Instruments and Evolution). Using data from the three editions of the Mexican National Survey of Financial Inclusion (ENIF) (2012, 2015 and 2018), this report provides an overview of savings in the country.

According to its report, the percentage of the adult population who actively saved (i.e., when a person sets aside money for the future using formal or informal instruments) was 51% in 2012, rising by 17 percentage points (pp) to 68.0% in 2018. Drilling down into the figures, the percentage of the adult population who saved using informal instruments (instruments not regulated or supervised by a governmental institution) rose from 44.0% to 63.0%–an increase close to 20pp. In 2018, the percentage of the adult population using formal instruments to save was 20.0%, which is 5pp higher than in 2012.

The report included an econometric model (Probit model) to identify the socio-demographic factors that affect the rate of saving. Specifically, the model was applied in four scenarios: saving using informal instruments, saving using formal instruments, holding a bank account and using debit cards. The independent variables used were: the number of years completed in school, age, formal employment, living in an urban location, being female, having a monthly income lower than (greater than or equal to) 5,300 pesos, among others. According to the report, the variable that has the greatest marginal effect on the likelihood of saving using informal instruments is income. In particular, receiving a monthly income equal to or greater than 5,300 pesos increases the probability of saving through these instruments by 17%.

As for the factors that influence saving using formal instruments, the model identified that having taken out some form of formal credit resulted in a 10.0% increase in the probability of saving using this type of instrument. It also found that people with an income greater than or equal to 5,300 pesos were 9.0% more likely to save. With regard to holding an account and using debit cards, the model showed that formal employment had the greatest impact on the likelihood of saving: 40.0% in the case of holding an account and 20.0% for debit cards. Finally, it is important to note that the factor of "overspending" was ranked as one of the most significant in terms of its negative influence on the probability of saving (-10.0% informal, -9.0% formal), holding an account (-3.0%) and using debit cards (-4.0%).

Lending contracted in nearly all regions of the country in 4Q20

According to the Bank of Mexico's Regional Economies Report[1] and based on the Credit Market Assessment Survey (EECMC), during 4Q20, the percentage of companies to use commercial banking as a source of financing declined in the Central (-3.5%), North Central (-14.5%) and South regions (-2.0%), while it remained at a similar level in the North (0.7%) on a quarterly basis. Compared to 4Q19, the percentage of businesses borrowing from banks decreased 7.0% across the country, with the largest drop in the North Central region (-13.8%), followed by the North (-7.6%), the Central (-4.6%) and South (-3.6%) regions. Financing via suppliers and using own funds grew in all regions except the North, where the proportions of using such sources also decreased.

In commercial banking, the portfolio of outstanding loans to non-financial private companies showed a real annual contraction[2] of 5.0% in 4Q20–the second consecutive quarter with a year-on-year fall. Bank financing in the country's Central region, which accounted for 55.0% of 4Q20 lending, contributed -4.6pp to this decrease, while -0.4pp was attributable to the North and -0.32pp to the country's North Central region. The South region constituted 7.0% of the outstanding portfolio in commercial banking and saw real growth of 4.6% during the period in question, contributing 0.3pp to the real annual change in outstanding loan balances.

By type of activity, changes in the outstanding loan book in 4Q20 varied significantly. The agricultural sector in the North borrowed more, with real annual growth of 5.8%. In contrast, the balances of outstanding loans to the primary sector shrank in the North Central (-6.3%), Central (-21.1%) and South Central (-4.9%) regions. The portfolio of outstanding loans to industry decreased in the Central region (-11.5%), but grew in the North (1.9%), North Central (1.0%) and South (1.5%) regions. Outstanding loans to service sectors were 7.7% higher in the South of the country, along with declines in the North (-7.2%), North Central (-2.8%) and Central (-4.7%) regions.

According to our analysis, industry will rebound before most services; therefore, how entities and regions recover will largely depend on the sector composition of production in each state. An improvement in business managers' expectations, as well as brighter consumer confidence indicators in most regions could suggest demand will pick up, which is necessary to sustain the growth in activity. The relative pace and magnitude of such a recovery for each type of activity and in each region are fundamental variables for analyzing potential demand in the credit market.

Why did corporate insolvency not significantly increase despite the economic downturn? *BIS bulletin*

According to the Bank for International Settlements (BIS), during 2020 the number of companies that became insolvent in developed countries remained low and even declined in some of them. This fact is notable because according to theory and historical information, it was expected that several companies would have moved from having a liquidity problem to becoming insolvent due to the global recession stemming from Covid-19.

1: Regional classification in the report: The North includes Baja California, Chihuahua, Coahuila, Nuevo León, Sonora and Tamaulipas; the North Central region covers Aguascalientes, Baja California Sur, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas; the Central region is made up of Mexico City, Mexico State, Guanajuato, Hidalgo, Morelos, Puebla, Querétaro and Tlaxcala; and the South, Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán.
2: It should be noted that the real variation does not include exchange rate effects.

According to BIS, this gap between the expected corporate bankruptcy rate based on economic activity indicators and the observed data (the Covid-19 bankruptcy gap) can be explained by two factors. The first is the asymmetric exposure to the pandemic of different sectors and their pre-existing vulnerabilities. Corporate data for the G20 and Spanish economies indicate that a reduction in revenue is not the only variable that has influenced the risk of insolvency between sectors.

While it is known that services–particularly those related with tourism (i.e. airlines, hotels, restaurants)–have been seen their revenues fall the most due to the pandemic, there are sectors such as Entertainment and Consumer Discretionary whose revenues were also severely affected. However, they managed to mitigate the risk of insolvency because of their low pre-pandemic vulnerabilities in terms of liquidity and indebtedness. Similarly, there are sectors with high debt vulnerabilities (e.g. construction and housing) whose exposure to the effects of the pandemic has been lower.

The second factor is the ample supply of credit, boosted by unprecedented fiscal and monetary stimuli in developed countries. Based on information from 11,000 non-financial companies across nine advanced economies, the BIS report noted that debt among loss-making firms increased between 4Q19 and 3Q20. The percent increase on the amount borrowed exceeded that of their losses (as a percentage of their assets) for 10.0% of the companies analyzed. That is, losses were covered with credit.

Moreover, the study found that credit extension has been especially generous for companies in the sectors most exposed to Covid (airlines, hotels, restaurants, entertainment, textiles, luxury goods and clothing), since for almost all of these, the percentage increase in debt has been higher than their losses as a percentage of assets. This ample supply of credit sets the Covid crisis apart from the 2008 crisis, because after the collapse of Lehman Brothers, lending conditions remained tight.

The study concluded that, in light of higher leverage, the uncertain outlook for cash flows in the coming months and the role of credit in suppressing bankruptcies in advanced economies, the capacity to absorb losses in the banking sector will have to be closely monitored, as will the evolution of lending conditions, which affect the ability of companies to refinance their debts.

2. Financial markets

Rise in asset prices linked to cyclical recovery among gradual but uneven recovery of economies. The peso appreciated in March.

In March, the prevailing narrative of reflation shaped movements in the financial markets, albeit with increasingly clear evidence of regions rebounding at different rates.

Consensus among market participants points to a vigorous recovery in global economic activity accompanied by higher real long-term interest rates and greater inflation expectations. Buoyed by the announcement from the Federal Reserve Board (the Fed), the market now considers that the expected increase in prices will be short-lived. Thus, the expectation is that short-term interest rates will remain at their current levels for a long time. This is especially true, given that the chairman of the Fed explicitly pointed out that the Federal Open Market Committee (FOMC) will not act preventively based on expectations, but on observed data.

While this is the dominant market narrative, differing vaccination rates between countries has led to a regional divergence in expectations of a recovery, with the North American market predicted to bounce back more quickly. Today, analysts forecast for real growth rate in 2021 stand at 4.2% for the Eurozone, 5.2% for the Asia Pacific region (China 8.5%) and 5.6% for North America (USA: 5.7%). It should be noted that expectations of the US economy's dynamism were underpinned by President Biden's latest proposal for a USD 2.5 trillion infrastructure plan in addition to the approval of the USD 1.9 trillion tax aid package approved weeks ago.

In this context, risk asset prices rose more moderately and experienced greater swings because of the shift toward assets and regions most dependent on the cyclical recovery. In particular, the stock markets recorded moderate gains consistent with the gradual and uneven reopening of the economies, especially in early March. The global benchmark for this asset class (MSCI World) posted gains of 3.1% in the third month of the year, while in the US, the S&P500 advanced 4.2%, Nasdaq 0.4% and the Russell 2000 rose 0.9% over the same period. Emerging Markets (MSCI EM) recorded losses (-1.7%) in March influenced by higher long-term interest rates and the strengthening of the dollar. The IPC performed well with a 6.0% increase during the month.

It should be noted that during the first two weeks of March, before several European countries announced new lockdown measures and before the Fed's meeting, the Russell 2000 led the gains of the US indexes, with an increase of 6.9% (S&P500 [3.5%], Nasdaq [1.0%]). This is consistent with the cyclical rotation of stocks and the rise in long-term interest rates.

In addition, toward the last third of the month, market performance was affected by an increase in volatility as a result of the Archegos fund defaulting on a margin call. This triggered a fire sale of stocks with adverse effects mainly for several investment banks. While the impact of this episode was limited in terms of the financial system as a whole, it was a wake-up call regarding the significant leverage in the positions of these types of participants.

In the fixed income market, long-term interest rates continued to increase pushed up by hopes of an economic recovery and fiscal stimuli. The ten-year Treasury bond yield rose 34 base points (bp), closing the month at around 1.74%. This was its highest level since January 2020 and represented an increase of 83bp during the first quarter of 2021. The Fed's announcement kept the short part of the curve anchored at 0.16%, changing the slope from 128 to 158bp between the end of February and March. This has been beneficial to the shares of banking institutions, which in the US recorded a 6.0% increase in March as measured by the KBW banking index.

In Mexico, the yield to maturity of the 10-year Mbono rose by 59bp, closing the month at 6.84%. This level is the highest since April 2020 and represented an increase of 128bp during the first quarter of this year. This significant rise, in addition to the increase in the US long rate, can be explained by the unexpected rise in inflation in the first half of March. This, in turn, influenced the Bank of Mexico's decision to leave the monetary policy rate unchanged (4.0%), in what appears to be the end of the cycle of monetary easing.

The combination of a stronger recovery and higher interest rates in the US strengthened the US dollar. In March the dollar gained 2.6% against currencies of developed countries and appreciated 1.1% against emerging markets' currencies in the same period. In this context, the Mexican peso outperformed and closed the month up 2.0%, the second highest appreciation among emerging market currencies. As such, the exchange rate closed March at 20.43 pesos per dollar.

Despite this monthly appreciation, the peso was volatile. During the first 10 days of March, the peso fell 3.0% from the end of February as long-term rates in the US rose sharply. This led to the exchange rate climbing to above 21.5 pesos per dollar. The peso subsequently benefited from an apparent divergence of EM currencies following the sharp depreciation of the Turkish lira in response to the removal of the governor of the country's central bank, and the deterioration of the Brazilian economy due to the continuing rise in Covid-19 cases. There is even a hypothesis that the Mexican peso and the South African rand–the two currencies enjoying the highest gains in March–were used to hedge the risks associated with Turkey and Brazil.

Looking ahead, financial market prices are expected to continue benefiting from the shift toward assets aligned with the narrative of a heterogeneous cyclical recovery against a backdrop of higher global interest rates. However, it is possible that periods of volatility lie ahead as economic indicators provide more evidence of the nature and duration of the recent rise in inflation expectations. It should be noted that risk asset prices continue to be underpinned by expectations of low interest rates. Thus, any signals to market participants that inflation may be more persistent than envisaged could lead to some of the cumulative gains being eroded.

3. Regulation

CNBV/Banxico: Monitoring the Migrants and relatives Support Program

As part of the program to support migrants and their families announced on February 8 by the financial authorities and the Mexican Banking Association, on March 10, the National Banking and Securities Commission submitted to public consultation a resolution amending the General Provisions applicable to credit institutions which in addition to voter identification cards and passports issued in the country, would include consular registration cards and passports issued by consular offices, thereby increasing migrants' access to banking. In addition, the project limits the regulatory requirements only for Level 4 accounts (highest KYC level) regarding identity theft prevention (identification for signing contracts and conducting face-to-face and remote operations, identity verification, biometric verification, etc.).

On March 11, Banxico issued two consultations on this support program:

1. Draft rules for contingent financing by the Bank of Mexico secured with US dollars or government securities. This establishes the conditions so that institutions acquiring dollars in cash as part of their ordinary operations that cannot remit them to an external financial institution for their sale, can apply for a simple contingent credit from Banxico secured by the proceeds of the sale of these funds or by government securities.
2. Draft of amendments to Circular 3/2012, regarding sight deposit accounts of Mexican individuals residing abroad and prepaid bank cards denominated in domestic currency. This establishes the regulatory framework for sight deposits of Mexican individuals residing abroad (characteristics, levels of transactions, limitations, requirements and conditions). It also includes a section on prepaid bank card characteristics (offer, use, limits, security measures).

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