Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Bank credit to the private sector contracted by 8.8% in April due to base effects and inertia in demand recovery

In April 2021, the nominal balance of the current loan portfolio granted by commercial banking to the non-financial private sector (NFPS) fell 8.8% year-on-year. The reduction in nominal balances was even larger than in March, which saw a nominal contraction of 7.9%, making it the largest decline since the downward trend began in May 2020. During March and April, these year-on-year changes reflected a significant base effect as a result of companies using credit facilities at the start of the pandemic.

The annual nominal changes in the credit aggregates that make up the country's NFPS were as follows: consumption, -6.6% (compared to -9.2% in the previous month and 0.2% in April 2020); housing, 8.7% (8.5% in the previous month and 9.6% in April 2020); and companies, -14.9% (-12.6% in the previous month and 16.0% in April 2020). During April 2021, contributions to the contraction of 8.8 percentage points (pp) in bank credit to the NFPS were (in descending order): housing, 1.6 pp; consumption, -1.4 pp; and companies, -9.1 pp.

The appreciation of the peso on a year-on-year basis during April 2021 exacerbated the fall in the outstanding nominal balances of the corporate portfolio in foreign currency for that month. Expressed in pesos, this portfolio showed a nominal change of -33.2% (-32.5% in the previous month and 44.9% in April 2020), while in dollars, it was equivalent to -20.8% (-22.4% in the previous month and 15.1% in April 2020). In turn, existing nominal balances in domestic currency fell 8.1% in April (after having fallen 4.9% in the previous month and having grown 7.9% in April 2020), the third consecutive month in negative territory.

The base effect influenced the fall in traditional deposits in April. There is still no evidence that balances accumulated during the pandemic have been spent.

The behavior of bank deposits in the wake of the pandemic has been clear: significant growth in demand deposits, particularly from individuals, has more than offset the slump in term deposits. Given that the rise in demand deposits can be associated with temporary and pandemic-related constraints, the underlying question is: By how much and how fast will households and companies reduce their accumulated cash balances, given the reduction in COVID-19 cases and the progress of vaccination?

Deposits during April provide some indications, although they are still far from giving clear signs of an answer, which will gradually become known in the coming months. All the more so because during April, annual growth rates were influenced by an unfavorable comparison base effect following the significant increase in company and household deposits at the start of the pandemic.

Specifically, traditional deposits (demand + term) in April recorded a nominal annual growth of -1.9% (-7.5% real) as a result of a nominal annual growth of 7.1% (1.0% real) in demand deposits and a further nominal annual fall of 15.9% (-20.7% real) in term deposits. Once again, the fastest growing segment was demand deposits from individuals, which grew 15.1% year-on-year in nominal terms (8.5% real), its 16th consecutive double-digit annual growth rate.

This is the first time that traditional deposits have shown an annual decline in nominal terms for as long as records are available (December 2006). As mentioned, this contraction is influenced by the comparison with April 2020. During that month, deposits increased by MXN 184 billion from the previous month, a figure that brought deposits to an all-time high, following an increase of MXN 472 billion in March. In other words, given the preference for liquidity and the restrictions on consumption due to the pandemic, between March and April 2020, traditional deposits grew by 657 billion, equivalent to 1.9 times the average annual growth in deposits since 2006. The comparison with these levels is clearly unfavorable.

Financial Stability Report: Banco de México

The main message that the Central Bank highlighted in its Financial Stability Report is that the financial system continued to show resilience in the face of the adverse effects of the pandemic and was characterized by high levels of capital and ample liquidity, both above the minimum regulatory levels. It does note, however, that various macro-financial and environmental risks will remain latent.

As regards commercial banking, the report notes that it showed improvements in its capitalization and liquidity levels. The capitalization level increased from 17.2% in September 2020 to 18.3% in March 2021. This improvement was influenced by the banks following the recommendation of the financial authorities not to distribute dividends, as well as by the reduction in the loan portfolio.

In addition, there was a reduction in market risk measured by the conditional value at risk (CVaR), the level of which was lower in April (3.6%) than the 2020 annual average (4.1%). In contrast, there was an increase in credit risk. The CVaR of the portfolio increased from 10.9% in September 2020 to 12.6% in March 2021, mainly because of higher default correlations. The report notes that, going forward, the evolution of credit risk will continue to be determined by the performance of economic activity, specifically employment.

Development banking shows high portfolio concentrations, although 80% of the portfolio is highly rated (lower risk). A decline in the probability of default has been observed recently, resulting in increased reserves.

As for the rest of the institutions that make up the financial system, SIEFOREs (*Sociedades de Inversión Especializada en Fondos para el Retiro* — Mexican specialized retirement fund investment companies) had temporary losses in February and March. However, as of March 2021, the funds had accumulated capital gains as compared to September 2020. The investments made were concentrated mainly in the long portion of the curve, which increased the duration of most of the SIEFOREs' portfolios.

In mutual funds, the most notable feature was the change in the composition of the equity segment, characterized by a relative decrease in liquid assets in favor of equities, certificates of deposit and PRLVs (*pagarés con rendimiento liquidable al vencimiento* — promissory notes with yield payable at maturity).

As for the insurance and surety sector, a real annual decline of 2.4% was recorded for direct premiums between the first quarter of 2021 and the end of the previous year. It should be noted that, despite this decrease, the claims ratio increased in life and medical expenditures.

Finally, the report lists the most significant risks to financial stability: 1) More restrictive and volatile global conditions due to higher interest rates and inflation in advanced economies. 2) Economic recovery with greater heterogeneity across sectors and countries. 3) Weak domestic demand. 4) Sovereign and Pemex credit rating downgrades.

Credit contracted in all regions and activities in 1Q21

According to Banco de México's Report on regional economies[1], the outstanding commercial banking portfolio of non-financial private companies showed a real annual decline of [2]17.2% in 1Q21, exacerbating the contractionary trend in this variable during 3Q20 and 4Q20, with falls of 0.1% and 5.0%, respectively. Bank financing in the Central region, which accounts for 55% of credit, contributed -11.7 of these -17.2 percentage points (pp), while -3.6 pp are attributable to the Northern region, -1.3 pp to the North-Central region, and -0.5 to the Southern region.

The contraction in credit intermediation presented in the document includes the month of March, which already reflects a significant base effect and, as noted previously, the increased use of credit facilities by companies at the onset of the COVID-19 health crisis.

In terms of the portfolio by type of activity, during 1Q21, the agricultural sector presented a greater contraction in the country's Central and Southern regions, with real growth rates of -23.6% and -13.1%, respectively. The outstanding portfolio of primary activities in the North-Central region fell by 10.7%, while the Northern region had a decline of 4.7%. In industry, the largest drop also occurred in the Central region, with a real annual change of -20.7%, followed by the Northern (-15.9%), North-Central (-7.5%) and Southern (-6.6%) regions. In the services sector, the Northern region experienced the largest real annual contraction (-20.4%), followed by the Central region (-20.2%). The decreases in the outstanding portfolio of tertiary activities in the North-Central and South-Central regions were -8.5% and -9.0%, respectively.

According to our analysis, although the use of credit facilities by companies at the beginning of the pandemic generated a significant base effect on credit indicators during 1Q21 and 2Q21, the inertia in demand recovery and insufficient capital flows toward investment projects mean that the expectation of recovery in credit indicators is still in the medium-term horizon. The revitalization of activity and a boost in investment in specific activities will result in

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, Queretaro and Tlaxcala; and the Southern region encompasses Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatan.
2: It should be noted that the real variation does not include exchange rate effects.

heterogeneous growth at the regional level, depending on the share of sectors in the different regions and on incentives to reactivate flows of investment.

2. Financial markets

The Fed's communication managed to maintain risk appetite, even as the expectation of interest rate hikes began to enter the conversation.

During June, the Federal Reserve's announcement set the tone for movements in financial markets. The prevailing narrative among market participants is that the current rise in inflation is transitory and, given that the US labor market is still far from returning to full employment, US interest rates can be expected to remain at low levels for some time to come.

This generic narrative started to become more nuanced on June 16 when the median of FOMC members' Federal Funds rate projections (the dot plot) showed that two rate hikes are expected by 2023. Even though the Fed Chair attempted to nuance these projections and emphasized that it was not yet time to discuss the timing of interest rate hikes, the markets read this message as clearly restrictive. This was reflected in a sale of government bonds that led to a rise in both the short and long portions of the curve, losses in equity markets and a widespread strengthening of the dollar.

A week later, in his congressional testimony, the Fed Chair reiterated the message that it was too early to discuss the rate-hike cycle, so the idea that rates will remain low for an extended period of time once again took hold among market participants. As a result, risk appetite was reactivated. However, the effects of the announcement across markets were mixed.

In the fixed income market, the most significant movement was the rise in short-term rates. The yield to maturity on the 2-year Treasury bond rose by 9.0 bps after the Fed meeting, ending the month 11 bps higher. As a result, the 2-year Treasury bond closed at a yield of 0.25%, its highest level in 15 months. The yield to maturity on the 5-year bond rose 9.0 bps in June to close at 0.9%, its highest level since March.

In the long portion of the curve, the strong upward movement after the Fed meeting (8 bp) faded after a few days and the yield to maturity of the 10-year bond closed June at 1.47%, down 13 bp from the previous month. This drop, despite the incorporation of upward expectations in the short term, can be attributed to two factors. The first was that the market was anticipating more information on the discussion of a possible start to the tapering of the Fed's bond purchases. And the second was the reduction in the supply of long-term bonds in the coming months.

As a consequence of these movements in US interest rates, the slope of the yield curve between the 2- and 10-year maturities fell by 23.0 bps to 1.2%, its lowest level since last February.

Long-term rate dynamics in Mexico were disassociated from rate movements in the US as a result of higher than expected inflation and the unexpected monetary policy rate hike. Inflation in the first half of June stood at 6.0% year-on-year, well above analysts' expectations and the trajectory expected by the Central Bank itself. The same afternoon that the inflation figure was released, and highly influenced by it, Banxico raised its rate 25 bp. Given this, the swap curve priced a new cycle of monetary policy rate hikes of more than 100 bp for the remainder of 2021. In the face of rising short rate expectations and higher than expected price growth, the yield to maturity on the 10-year bond closed June up 39 bp at 7.0%, its highest level since last May.

In the foreign exchange market, the dollar recorded widespread gains after the interest rate hike in the short portion of the US curve, following the Fed's announcement. Developed currencies lost 3.0%, while emerging currencies fell 1.2% against the dollar. The Mexican peso performed positively as a result of the incorporation of a rate hike cycle into market expectations following Banxico's unexpected 25-bp hike. In fact, the Mexican peso was the third best performing currency during the sixth month of the year with a marginal gain of 0.1%. This was the result of a 1.3% appreciation after the monetary policy meeting, which exceeded the 1.2% depreciation of the peso in June before the policy meeting. Thus, the exchange rate closed the first half of the year at 19.9 pesos per dollar, after having traded at 20.2 pesos per dollar prior to the monetary policy meeting.

Finally, in the equity markets, the movements generated by the Fed's announcement favored growth stocks. The Nasdaq 100 rose 3.0% after the Fed's decision, ending June with a 5.5% growth rate, which put it at a new all-time high. In a similar vein, the S&P500 gained 1.2% after the Fed's meeting, and the gains stood at 2.2% for the month.

For the rest of the major equity markets, losses were recorded during the second half of the month, although this did not erase the gains made during the first two weeks. Thus, the global asset class benchmark (MSCI World) closed with a gain of 1.3% in June, while the emerging markets benchmark (MSCI EM) generated gains of 1.0% over the same period. The Mexican IPC stock market index closed the sixth month of the year with a gain of 0.5%, bringing it to 14.1% for the first half of the year.

The abrupt market movements following the release of the FOMC members' economic projections once again illustrated the extent to which current valuations were underpinned by the expectation of low rates for a prolonged period. Although most of these movements faded after a few days, it is important to note that as the year progresses, the evidence on the transitory nature of the price hike will have to be unraveled. Otherwise, market sensitivity to the Fed's announcement, or lack thereof, could increase, making it more difficult for the US central bank to effectively communicate how it will withdraw the stimulus underpinning asset prices.

3. Regulation

Plans under consultation

Banco de México — Draft amendment to Circular 3/2017 regarding the rules for foreign exchange hedge auctions.

It aims to establish a daily settlement system for forex hedges that credit institutions implement with Banxico, replacing the current scheme of guarantees with a daily valuation of the forex hedges that have been entered into, such that the institutions receive or settle the daily gains or losses pertaining to them.

A calendar of non-working days in the US has also been incorporated so that credit institutions involved in the forex hedging mechanism can improve their chances of adequately hedging the foreign exchange risk arising from the maturity of such transactions.

Banco de México and CNBV (*Comisión Nacional Bancaria y de Valores* — National Banking and Securities Commission) — Draft general provisions on liquidity requirements for commercial banks (LCR - NSFR)

The new provisions aim to add the net stable funding ratio (NSFR) to the already existing liquidity coverage ratio (LCR) and to establish its accounting treatment and calculation method, reporting and publication obligations, scenarios and corrective measures, and restoration plans.

Publications in the *Diario Oficial de la Federación* (Official Gazette of the Mexican Federation)

- 06.18 The CNBV published the Resolution amending the general provisions applicable to credit institutions, regarding the adoption of the international total loss absorbing capacity (TLAC) standard. The aim is to improve financial stability and mitigate the risk represented by banks of local systemic importance, adapting the regulations applicable to the absorption of losses and the internal recapitalization capacity of these entities during a resolution process, without interrupting their critical functions and without needing to call on public resources.

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