Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Bank credit to the non-financial private sector fell 7.4% in May, which could mark a turning point in its performance

In May 2021, the nominal balance of the current loan portfolio granted by commercial banks to the non-financial private sector (NFPS) fell 7.4% year-on-year (-12.6% in real terms). This decrease in nominal balances was smaller than in March and April (-7.9% and -8.9% respectively), months in which there was a significant base effect in the year-on-year comparison due to the growth observed during the same months of 2020 as a result of the use of corporate credit lines.

With respect to the corporate portfolio, comparing the period from March to May in 2020 and the same period in 2021 makes it possible to identify which sectors are experiencing a fall as a result of an accounting effect and those in which there has been a notable decrease in demand for financing.

As for the consumer portfolio, decreases in most segments slowed in nominal terms, which could be attributed to the recent improvement in consumption and employment indicators, but also to the accounting effect of higher inflation.

The housing portfolio remains the only one to maintain positive growth rates in both nominal and real terms, although with a downward trend, which may be starting to reflect the shrinking of the potential market due to the decline in formal job generation seen since 2019, which has a somewhat delayed impact on this portfolio.

The delinquency rate of the corporate portfolio in May 2021 was 2.1%, slightly higher than the previous month and the 1.8% seen in May 2020, while the consumer portfolio had a delinquency rate of 4.2% in May 2021 (4.4% in the previous month and 4.8% in May 2020). The delinquency rate of the housing portfolio was 3.6%, which was similar to the previous month but 50 basis points (bp) above the figure for May 2020.

May could mark a turning point in the dynamics of total NFPS credit, with an aggregate contraction lower than that seen in April and improved performance in the portfolios of which it is composed, this being the result of a smaller contraction (in the case of corporate and consumer) and of ongoing positive growth (in the case of housing). A sustained improvement in activity and employment indicators in the medium term would consolidate improved performance in the credit market.

Signs of changing bank deposit trends in May

The increase in demand deposits from individuals accounts to 52% of the significant rise in bank deposits between February 2020 and April 2021, following the outbreak of the COVID-19 pandemic. The preference for liquidity, the fall in consumption and the wage heterogeneity of unemployment are some of the main contributing factors behind this unusual increase in deposits from individuals.

With respect to these unusual dynamics of demand deposits, questions immediately rise regarding their duration and the speed at which they will burn out. While these questions will be answered with greater precision over the coming months, the data from May could start to give us an idea of things to come.

Indeed, May was the second consecutive month in which traditional deposits experienced negative annual growth, falling by 0.6% in nominal terms (-6.2% in real terms). This is the result of a 15.3% drop (-20.0% in real terms) in term deposits, a marginally lower drop than in April; and of an 8.7% nominal annual increase (2.7% in real terms) in demand deposits.

Individual deposits, a subset of demand deposits, slowed but also registered a nominal annual increase of 10.6% (4.4% in real terms), marking 17 consecutive months with double-digit growth. Corporate deposits rebounded to a nominal annual level of 2.5% (8.5% in real terms), following nominal growth of just 1.3% in April.

As in previous months, base effects impact annual growth. However, a review of the monthly growth indicates that demand deposits from households have reduced significantly, which may indicate that households have begun to spend the funds accumulated during the pandemic.

Commercial banking institutions recorded deposit and loan portfolio balances equivalent to 23.8% and 20.7% of GDP, respectively

According to the Financial Savings and Financing Report published by the National Banking and Securities Commission (CNBV) on July 1, 2021, financial savings in 2020 represented 102.1% of GDP[1], with a cumulative balance of MXN 25.3 trillion. Of this figure, MXN 9 trillion (35.4% of GDP) corresponds to deposits by intermediaries, MXN 9.3 trillion (36.6% of GDP) corresponds to the holding of fixed income securities and trust stock certificates, while MXN 7.1 trillion (28% of GDP) comes from foreign savings.

Within intermediary deposits, commercial banking grew 10.4% year on year between December 2019 and December 2020, rising to MXN 5.9 trillion (23.8% of GDP). Development banking saw a real year-on-year reduction of 4.6%, with a balance at December 2020 of MXN 0.9 trillion (3.5% of GDP).

The holding of fixed income securities and trust stock certificates increased by 7.1% throughout the year in real terms, with a balance at December 2020 of MXN 9.3 trillion (37.4% of GDP). Institutional investors (insurers, investment funds, retirement funds and SIEFOREs [*Sociedades de Inversión Especializada en Fondos para el Retiro* — Mexican specialized retirement fund investment companies]) account for 68% of this segment, while private investors (stock

[1] GDP as of December 2020.

exchanges, companies, private individuals and relevant treasuries) account for the remaining 32%. Among these latter holders, of particular note is the real annual contraction of 22.6% in the holdings of stock exchanges (own position), from 0.2% to 0.1% of GDP from December 2019 to December 2020.

In terms of total public and private sector financing, real annual growth of 3.5% in December 2020 brought the balances to MXN 25.1 trillion (101.4% of GDP). As of December 2020, the balance of domestic financing was MXN 20.3 trillion (81.8% of GDP), while external financing had a balance of MXN 4.9 trillion (19.6% of GDP).

The issuance of domestic debt and trust stock certificates accounts for the largest share of total financing sources, at MXN 11.5 trillion (46.3% of GDP), followed by bank credit, with a balance of MXN 5.1 trillion (20.7% of GDP), other intermediaries, with a balance of MXN 2.9 trillion (14% of GDP) and development banking credit, with a balance of MXN 0.8 trillion (4% of GDP). In terms of financing destinations, 45.6% went to the private sector (MXN 9.3 trillion, 37.3% of GDP), while 54.4% (MXN 11 trillion, 44.5% of GDP) went to the public sector.

From December 2019 to December 2020, the commercial banking portfolio total experienced a fall of 4.3%, while the development banking portfolio increased by 5.4% (real annual growth). It should be noted that, during this period, public sector financing increased 5.2% (real annual growth), while private sector financing contracted by 1.7%.

2. Financial markets

New COVID-19 outbreaks and a slowdown in China led to a significant fall in long-term interest rates in the United States

The uncertainty surrounding the strength of the economic recovery in 2021 shaped the performance of the financial markets in May. Doubts regarding the narrative of a vigorous economic recovery emerged among market participants as COVID-19 cases increased and the Chinese economy slowed. This is all occurring in an environment in which fiscal stimuli in the United States will end in the coming months and in which President Biden's proposed infrastructure plan was scaled back during negotiations with legislators.

These doubts around the prevailing market narrative were reflected, mainly, in a position contrary to the so-called reflation trade, leading to significant changes in some of the prices of financial assets. It is important to note that, as on other occasions, the signs sent by prices in the different markets do not seem to be entirely aligned with the changes to the narrative.

The most significant changes were seen in the **fixed income market**. Treasury bond yields declined throughout the curve, in line with doubts surrounding the vigorous economic recovery. However, the largest falls occurred in the long part of the curve. The yield to maturity of the 10-year Treasury bond fell 25 bp in July and closed the month at 1.22%, its lowest level since mid-February. The smaller drop in yields in the short part of the curve (6 bp in the 2-year node) led to a reduction in the slope in the curve of around 18 bp in July, bringing this indicator to just above 100 bp, a level not observed since the end of January.

This reduction in nominal yields can be explained by a temporary fall in medium-term inflation expectations, but also and principally, by a fall in real yields. Medium-term inflation expectations for the US economy, measured by the 5-year/5-year forward breakeven rate, hit their lowest level since March. On the other hand, the **real 10-year yield in the United States reached a new historic low** at the end of July, when a level of -1.16% was recorded. These data indicate that the idea that the recent rise in inflation will be temporary appears to be gaining traction among market participants, and they reflect the idea that the recovery of the US labor market is still a faraway prospect. Both arguments have been repeatedly emphasized by the Fed.

The fall in Treasury bond yields has had a smaller than expected effect on Mexican bond rates, given the significant rise in inflation and the unexpected rise in the monetary policy rate in June. The yield to maturity of the 10-year bond fell by 9 bp in July, placing this indicator at 6.9% at the end of that month. While market expectations of an upcoming rate hike cycle have been moderated, the monetary policy rate is still expected to rise by just under 100 bp toward the end of 2021. This, coupled with inflation figures that have consistently been above the consensus among analysts (5.75% in the first half of July), has kept the trend for the 10-year rate at levels close to 7%.

On the other hand, there was differentiated behavior between the various indices in the **equity market**. In line with the weakening of the reflation trade, a sale of securities was recorded that was strongly linked with the cyclical recovery of the economy, this being reflected in a 3.65% drop in the Russell 2000 Index in July. This is the first monthly decline in this index since September 2020. Similarly, the emerging markets index (MSCI EM) fell 7.04% in July, the largest monthly decline since March 2020. It is important to highlight that this fall was heavily influenced by the collapse of Chinese equities toward the end of the month as a result of regulatory changes announced by China affecting online education companies, in conjunction with several recent episodes in which the country's authorities have sought greater influence over technology companies.

Unlike the Russell 2000 Index and MSCI EM, in July the S&P 500 and NASDAQ grew 2.27% and 1.16%, respectively. This growth led to both indices reaching new historical highs. The differences between the signs from these equity markets and the fixed income market seem to be explained by the above-expected results during the second quarter (87.5% of S&P 500 companies had corporate reports at the end of July above the consensus among analysts) and by the performance of tech stocks, the valuation of which shows greater sensitivity to long-term rate movements.

In the **foreign exchange market**, the Mexican peso stood out among emerging currencies with an appreciation of 0.35% in July, when all of these currencies depreciated 0.96% against the US dollar. This appreciation made it the third most appreciated emerging currency, and this was influenced by the expectation that Banxico would begin a cycle of monetary tightening in the coming months.

The **commodity market** experienced a slowdown in price growth. Monthly growth of the benchmark for this asset class (S&P GSCI) slowed from 3.23% in June to 0.96% in July. However, within the index, industrial metal prices rose again in July (+3.66%) after falling (-3.46%) the previous month. Energy price growth slowed from 9.34% in June to 1.76% in July, with the Mexican oil mix price growing 1.4% in July. Following this monthly growth, the Mexican mix was again above USD 70 per barrel.

In the coming weeks, financial market participants will be watching economic reports for further evidence to suggest strong downward movements in government bond yields. While the risks of a third wave of COVID-19 and lower growth in the Chinese economy are significant, for the time being, the expected loss does not seem to be large enough to significantly reduce the magnitude of the economic recovery. In any case, in an economic context of significant unknowns and before the next Fed meeting in Jackson Hole, markets will seek to strengthen the narrative that drives asset prices, with a summer of significant volatility therefore being foreseeable.

3. Regulation

Plans under consultation

CNBV — Resolution amending the general provisions applicable to credit institutions (commission agents)

The project includes multiple adjustments in relation to commission agents, including: clarification and extension of services exempted from the regime provided for in the regulation, and the introduction of confirmation of such exemption instead of prior authorization. The project also adds flexibility to the process of enlisting agents for the trading of dollars (previously, purchase was limited to accommodation establishments). The procedure to be followed when seeking to carry out transactions further to those authorized in the strategic plan, or to introduce a new technology to operate with commission agents, is also set out, and it is stipulated that the institutions must present a Commission Agent Certification Form, with information from relevant pre-operation tests. On the other hand, the list of entities prevented from acting as commission agents (including foreign exchange centers, non-associated pawnbrokers and stock exchanges) has been removed.

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

- 20.07 The CNBV published the Resolution amending the general provisions applicable to credit institutions (Articles 1 and 2 bis 17), by means of which the regulatory capital requirements that the CNBV stipulates for banks are reduced, through the reduction of risk weightings for the consumer, SME and mortgage portfolios, wherein the loan-to-value ratio (“Razón CVV”) is being introduced to determine the aforementioned weighting.

- 23.07 The CNBV published the Resolution amending the general provisions applicable to credit institutions, concerning credit granted to women, through which the lower default rate observed among women is recognized and reflected in the loan-loss provisioning methodologies for the non-revolving consumer and housing mortgage portfolios.

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