Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

The recovery of bank credit balances in July was not enough to generate positive annual growth rates

In July 2021, the nominal balance of the current loan portfolio granted by commercial banking to the non-financial private sector (NFPS) fell 4.0% year-on-year (-9.3% in real terms). For the third consecutive month, the contraction in the annual growth rate of the current portfolio balance has decreased, thereby reaffirming that total bank credit is on the road to recovery, although the extent of this recovery differs across portfolios. The nominal growth rates in the aggregates comprising the NFPS were: companies, -9.7%; consumption, -0.4%; and housing, 9.1%.

In the case of the consumer portfolio, the upturn in nominal terms of some segments has continued, with the remaining segments, aside from automotive loans, experiencing a decline in the scale of contractions. The consumer durable goods and payroll loan portfolios recorded nominal growth, although in real terms both remain in negative territory. Personal and credit card loans continue to record negative annual changes, albeit of a significantly reduced magnitude.

For business loans, the improvement in sectoral activity and business confidence indicators has not been sufficient to generate real growth in the financing of some production activities. Although the overall effect is a smaller contraction than in previous months, lending to certain production activities, including in the mining sector and the transportation equipment industry, dropped significantly in July. In several sectors, the third wave of infections could have delayed investment projects in the face of an uncertain outlook for the recovery of activity. In addition, the accumulation of deposits during the pandemic for precautionary reasons, along with the prudential delay in investment projects, could explain the inertia in the recovery of commercial banking financing to firms.

The housing portfolio has shown greater dynamism than in the previous month and reaffirmed its position as the only portfolio to maintain positive growth rates in nominal and real terms. Annual growth rates in job recovery have progressively increased since April 2021, which points to sustained medium-term growth in this portfolio.

Upon filtering out the nominal boost owing to inflation, a continued contraction in the consumer and corporate portfolios may be observed, albeit to a lesser extent than in recent months. Overall, the growth observed in economic activity indicators points to recovery, although levels are still well below those observed prior to the health crisis.

The uptick in employment and the third COVID wave accelerated the growth in deposits in July

The growth of bank deposits accelerated in July in the face of higher demand deposits by both individuals and firms. This behaviour may be related to the significant growth in formal employment combined with a slowdown in some areas of consumption following the uptick in COVID infections.

Traditional deposits grew by 0.7% in nominal terms (0.1% in real terms) in July, which also allowed for their first positive annual growth rate (0.1% in nominal terms) to be recorded after three consecutive months of decreases. This growth was again bolstered by a monthly increase in demand deposits of 1.46% in nominal terms (0.9% in real terms), which more than offset the 0.9% nominal reduction (-1.5 in real terms) in term deposits.

Despite a lack of closure of activities by authorities, COVID-19 outbreaks have not allowed households, in particular, to establish a more stable spending pattern in order to make use of cash balances accumulated during 2020. Moreover, the positive trend in formal employment in recent months renders the situation conducive to a new accumulation of demand deposits, especially given the preference for liquidity that both households and firms continue to show.

Following what happened throughout the pandemic, it is possible to assert that this new cycle of accumulating cash balances could continue in the short term. This was particularly the case in August, in which a record level of formal job creation was recorded, following the implementation of an outsourcing reform and facing the peak of the third COVID wave. The magnitude of these factors could theoretically outweigh the back-to-school increase in spending traditionally observed in August.

However, as the gains from formal employment level off, given their proximity to pre-pandemic levels, and the third wave of infections eases, we may see a phenomenon similar to that of the first and second quarters of the year, when bank deposits decreased moderately as consumption showed signs of recovery.

Update of balance of risks for the Mexican financial system

The Financial System Stability Council (CESF) has published an update to its balance of risks. The document highlights that global economic activity is still recovering—albeit at a slower pace than anticipated—and that this recovery has varied across countries and sectors, in an environment in which global inflation continues to increase (which could accelerate the withdrawal of monetary stimulus measures) and global financial markets have shown relative stability, although new episodes of volatility cannot be ruled out.

The CESF believes that there are ongoing external risks to the Mexican financial system related to more restrictive and volatile global financial conditions. In terms of domestic risks, it highlights those associated with less dynamism in domestic demand and the likelihood of impacts on the sovereign risk premium as well as the Pemex risk premium and credit rating.

The statement notes that the banking system has continued to show resilience and solid levels of capital and liquidity; however, despite the progressive recovery of economic activity, lending activity has still not picked back up. The performance of non-bank financial intermediaries has been mixed regarding their risk indicators. Due to their low participation in the financial system, this does not represent a potentially binding systemic risk.

Finally, the CESF analyzed the exposure of the external sector to peso-denominated assets, noting that the holding of government securities has continued to decline in recent months, while the holding of such instruments has increased among certain intermediaries in the financial system.

Liquidation of Accendo Banco, S.A., Institución de Banca Múltiple

On September 28, 2021, in a joint statement, the financial authorities notified Accendo Banco, S.A. of the revocation of its authorization to organize and operate as a commercial banking institution due to the fact that adjustments to the institution's accounting records required by the CNBV reflected a deterioration in capitalization levels, placing them below the minimum regulatory levels.

The Bank Savings Protection Institute (IPAB) will act as liquidator and carry out the payment of deposits and other public transactions that constitute secured obligations. The maximum amount covered by deposit insurance is 400,000 UDIs (equivalent to MXN 2,769,169.20 as of September 29, 2021). It is estimated that a payment will be made to 1,519 depositors, of which 96% are protected for the full amount of their savings and the remaining 4% will receive payment up to the insurance limit.

It should be noted that the situation of Accendo is a result of regulatory non-compliance, and is unrelated to the financial and economic scenario derived from the COVID-19 pandemic. In addition, the bank's assets represent 0.08% of the total in the system, so its liquidation does not pose a risk to the stability of the Mexican financial system as a whole.

Business loans continue to decline across all regions during 2Q21

According to the Bank of Mexico's Regional Economic Report[1], the current commercial banking portfolio of private non-financial firms registered a real annual decrease[2] of 17.7% in 2Q21, a slightly higher figure as compared to the 17.2% drop recorded in the previous quarter, marking 4 consecutive quarters in negative territory. Bank financing in the Central region, which accounts for 55% of credit, contributed -12.4 of these -17.6 pp, while -3.7 pp are attributable to the Northern region, -0.9 pp to the North-Central region, and -0.6 to the Southern region.

The contraction in credit intermediation presented in the document includes the month of June, during which a fall in credit balances during 2Q21—of a much greater magnitude than the growth experienced during the same quarter of 2020—can be observed in 3 of the 4 regions (representing 93% of the portfolio), which points to lower demand for financing, exacerbating the accounting effect that could be represented by the use of credit lines by firms during 2Q20.

In terms of the portfolio by type of activity, during 2Q21, the agricultural sector recorded the highest contractions in the country's Central and Southern regions, with real growth rates of -17.3% and -16.3%, respectively. In the case of the Southern region, the decrease in these balances is even greater than in 1Q21. The current portfolio of primary

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 take into account exchange rate effects.

activities in the North-Central region fell by 4.3%, while the Northern region experienced a decline of 1.0%, which were lower drops than those recorded in the previous quarter.

Similarly, the largest contraction in the case of industry was once again recorded in the Central region, with a real annual contraction of -20.8%, followed by the Northern (-16.7%), Southern (-11.4%) and North-Central (-6.9%) regions, with the latter being the only region with a lower decline than in 1Q21. In terms of tertiary activities, the Central region experienced the largest real annual contraction (-22.1%), followed by the Northern region (-20.5%). The decreases in the current portfolio of services in the North-Central and Southern regions were -6.0% and -9.5%, respectively.

According to our analysis, the recovery in activity has not yet translated into widespread growth across sectors and regions. The worst of the health crisis seems to have passed, with an overall resumption of indoor activities in several regions and expected recovery of employment and consumption indicators. In addition, bottlenecks in global supply chains seem to have started to clear. However, in order to boost the business loan market, it is necessary to foster an environment of certainty for flows of investment to resume, complementing the current expectation of higher incomes. The inertia in demand recovery could be explained largely by still-depressed demand owing to both the reluctance to direct capital toward investment projects and the possibility of balances accumulated in term deposits during the health crisis to act as a substitute for financing.

Support programs for banks and their debtors seem to have been effective in preventing a credit crisis: BIS Quarterly

In its most recent Quarterly Review, the Bank for International Settlements (BIS) reviews the effects of programs to support the flow of bank credit during and after the pandemic. In particular, it evaluates programs that are aimed at increasing banks' credit capacity by strengthening their capital and liquidity as well as those that provided incentives for banks to increase their credit by improving the risk/return ratio for the granting of new credit.

With regard to the strengthening of bank credit capacity, the assessment consists of quantifying whether banks that expanded their balance sheet capacity above that of their peers—measured by the change in capital to risk weighted assets and the change in the loan loss provisions to total assets ratio—also experienced higher credit growth.

Using a regression analysis, the BIS concludes that the 1.4% increase in capital as a proportion of risk-weighted assets in 2019 was associated with an 3.3% increase in the annual growth rate of credit during 2020. It should be noted that this effect was more intense during the first quarter of 2020, but continued to be present during the rest of the year.

In addition, the regression analysis makes it possible to conclude that lower increases in the loan loss provisions to total assets ratio are associated with higher increases in credit. Specifically, banks with increases at the midpoint of the distribution experienced credit growth of 2.2 pp annually as compared to banks in the 75th percentile of the distribution.

With regard to programs to increase credit granted through the influence of the risk/return ratio of new loans, mainly through guarantees, the BIS concludes that in countries in which the guarantee programs announced were more extensive, credit grew faster. This effect was most noticeable between the third quarter of 2020 and the first quarter of 2021. In addition, the document finds that SMEs in the sectors that were most affected by COVID-19 were more likely to expand their loans subject to maturities of more than one year in countries in which the guarantee programs were more generous.

In short, despite the wide range of measures, amounts and duration of support programs, the BIS concludes that support programs for banks and their borrowers appear to have been effective in cushioning the effects of the pandemic and preventing a credit crisis.

2. Financial markets

Rising interest rates and stock market losses in the face of expectations of higher inflation over a longer period

For financial markets, September brought about an adjustment to the assumptions underpinning the current narrative, as well as the introduction of greater global risks, all of which resulted in a significant reduction in risk asset prices.

The adjustment to the assumptions came on the inflation side. In recent months, market analyst consensus has been aligned with the Fed's position that the recent increase in prices is temporary. However, toward the last week of September, the chairpersons of the major central banks in developed countries made it clear that this 'transience' will be more prolonged and that high inflation levels will persist for longer than previously anticipated.

This, in addition to the fact that expectations regarding the federal funds rate hike, although still far off, were brought forward based on the recent projections of the members of the Fed's Open Market Committee (FOMC), renders the increase in the slope of the US bond yield curve unsurprising.

The Chinese real estate sector was a key player in the introduction of greater global risks. Fears of default by the real estate developer Evergrande and its potential spread to the rest of the markets triggered episodes of risk aversion during the week of September 20. While the effects were limited to these episodes, it became clear that the consequences of recent regulatory provisions regarding various sectors of the Chinese economy have not been fully incorporated into the prices of financial assets.

The main inflationary change following the adjustments to the narrative was the increase in long-term interest rates in the US curve. The 10-year Treasury bond's yield to maturity increased by 18.0 basis points (bp), closing September at 1.5%, its highest level since June.

Changes in Fed projections and the announcement that tapering would begin prior to the end of this year contributed to an increase in the short end of the curve that led the 2-year Treasury bond's yield to maturity to increase by 7 bp. With this, the slope of the yield curve (10Y-2Y) closed September at 1.2%, its highest level since June.

In Mexico, episodes of risk aversion and the upward revision of the Banxico inflation forecasts—after the observation of data that remained higher than expected—contributed to a 40-bp increase in the 10-year Mbono yield rate during September. With this, the indicator closed the month in question at 7.4%, its highest level since March 2020.

The introduction of risks and adjustments to the narrative was reflected in stock market losses. In the case of North American indices, the S&P 500 registered a 4.8% drop in September, its first monthly decline since January and largest decline since March 2020. The Nasdaq 100 index, which groups together major technology companies, fell by

5.3% in September, while the Russell 2000 index, comprised of small-cap companies, fell by 3.1%. These changes speak of the greater sensitivity of stocks of technology companies to the changes in long-term interest rates noted above.

With regard to global stock benchmarks (MSCI World) and emerging market benchmarks (MSCI EM), losses in September were 4.3% and 4.2%, respectively, while the Mexican IPC stock market index experienced losses of 3.6% in the same period.

Episodes of risk aversion, the change in FOMC expectations and a generally higher expected return in real terms on US instruments contributed to a widespread strengthening of the dollar. In September, the US currency experienced gains of 1.7% and 2.9% as compared to the currencies of developed and emerging countries, respectively. The Mexican peso depreciated by 2.8% against the dollar, with the exchange rate closing September at 20.6 pesos per dollar, its highest level since last March. This depreciation positioned the currency as the eighth most depreciated among emerging currencies.

The increase in energy prices almost single-handedly caused a 5.8% increase in the S&P GSCI commodities benchmark in September. This was due to the fact that energy prices were the only component to see increases during this period, albeit of around 11.0%. This is the result of significant price increases for products such as gas and oil, which, in the case of Brent, increased by 7.6% in September, nearly reaching USD 80 per barrel for the first time since 2018. In the case of the Mexican oil mix, the price per barrel already exceeded USD 70 following a 7.9% increase in September.

Bottlenecks across various sectors of the global economy in the context of the pandemic add a significant element of uncertainty to price dynamics. At the moment, the widespread expectation is that they are temporary. However, the longer inflation remains high, the more likely it is that this consensus could be called into question, which could result in early changes in short-term interest rates, the most important element in the current valuation of assets.

It will take several months for a verdict to be reached on the nature of this increase in prices. In the meantime, September could be an indication of changes to come in financial markets during the last quarter of the year.

3. Regulation

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

9.22 Banxico published Circular 6/2021, amending the Rules applicable to securities lending transactions. The publication adjusts certain definitions, clarifies the wording of the rule and includes the possibility of using securities lacking a national scale rating. Among other things, the rule includes insurance and surety institutions as lenders, as well as the CNSF (*Comisión Nacional de Seguros y Fianzas* — Mexican National Insurance and Surety Commission) as an authority; provides for the possibility of transactions being cleared and settled in central counterparty clearinghouses; recognizes master agreements approved by the Securities Industry and Financial Markets Association

(SIFMA) and the International Securities Lending Association (ISLA); and establishes in detail the characteristics of guarantees to be provided (pledges, stock market pledges, guarantee or administration trusts, and bank deposit payments or pledges), providing the application of an adjustment factor for said guarantees using a methodology that complies with the requirements set out in the rule.

9.23 The CNBV amended the General provisions applicable to credit institutions with regard to commission agents. These amendments include clarifications and broadening of services that are exempt from the regime provided for in the rule, as well as the flexibilization of the contracting of correspondents for the sale and purchase of dollars. They also detail the procedure for seeking to carry out additional transactions than those authorized in the strategic plan or for introducing a new technology to operate with commission agents, requiring institutions to submit a Correspondent Certification Form with information from relevant pre-operational tests, in addition to removing the list of entities banned from acting as bank commission agents (foreign exchange centers, unrelated pawn shops and brokerage houses). In addition, the amendments remove the 12-month period required to contract with commission agents who had previously served as exclusive correspondents for another institution.

9.23 The CNBV adjusted the “Resolution amending the general provisions applicable to credit institutions”, published on March 13, 2020, to allow credit institutions to choose to start using the effective interest rate as of January 1, 2022 or continue using the contractual rate for the duration of the 2022 financial year; this choice must be disclosed in their quarterly and annual financial statements and disclosed to the CNBV before the end of 2021.

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