Banking

Monthly Report on Banking and the Financial System

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1. Banking and the financial system

Bank deposits more stable than expected in August

The pandemic continues to weigh particularly heavily on fundamentals and explains the short-term fluctuations in bank deposits. Lower consumption and precautionary saving are factors that have favored the buildup of cash balances since March 2020.

August is usually characterized by a fall in the cash balances of individual accounts that is usually associated with back-to-school expenditure. In 2021, this decumulation of cash balances—though present—was far lower than expected.

It would appear that the pivotal point of the pandemic once again fed through into lower household consumption — reflected by both above-expected monthly growth in demand deposits and below-expected monthly growth in corporate deposits. This was accompanied by a fresh monthly decline in term deposits, which have experienced negative monthly growth for the last 16 months. Together, this meant that traditional deposits showed a slight monthly fall, which, nonetheless, was lower than expected for August.

Traditional deposits in August were down 0.2% in nominal terms (-0.4% in real terms), as a result of nominal monthly falls of 0.1% (-0.3% in real terms) in demand deposits and 0.4% (-0.5% in real terms) in term deposits. A breakdown of demand deposits shows deposits from individuals were down 0.6% in nominal monthly terms (-0.8% in real terms) and corporate deposits were up 1.1% (+0.9% in real terms).

In annual terms, it is a different story, given the low comparison point in August 2020. In the same month a year later, traditional bank deposits (demand + term) recorded a nominal year-on-year growth rate of 0.6% (-4.8% in real terms), showing a slight rise for the second consecutive month after the falls experienced between April and June this year, when the upturn in consumption began to reflect the availability of liquid assets that agents accumulated during the pandemic. Demand deposits have been the main driver of this recovery, with year-on-year nominal growth of 9.7% — enough to offset the double-digit fall in term deposits in the month (-14.2%).

Looking forward, the reduction in COVID-19 cases could see a rebound in consumption like that of the second quarter. However, it will be the absence of a new wave of infections this winter that will enable consumer expenditure—and therefore bank deposits—to normalize in the short term.

The recovery in corporate lending lags behind that of total lending

In August 2021, the nominal balance of the current loan portfolio granted by commercial banks to the non-financial private sector (NFPS) fell 3.1% year-on-year (-8.3% in real terms). This decrease was the smallest since March 2021, which not only signals that the accounting effect of the availability of corporate credit facilities in 2020 has diminished, but also that there has been a certain degree of recovery in the demand for bank financing.

Turning to the consumer portfolio, most segments performed better (either with higher growth or a lower fall) in nominal terms, even with a lower level of inflation than that recorded in July, which could be attributed to the recent improvement in household consumption and employment indicators.

There has been a contraction in nominal balances across the board in the corporate portfolio, with year-on-year declines in all productive activity. Nonetheless, analysis of the monthly growth rates demonstrates nominal and real growth in some of these activities, suggesting a pickup in demand for funding in certain sectors, which could be reflected in the unevenness of the recovery in the different sectors of the economy. Although investment and business confidence indicators point to a potential upturn in the corporate portfolio, it would appear that due to the inertia that exists, this is not happening at the same rate to the demand for corporate loans — so the recovery of corporate loans within total loans may be delayed.

The housing portfolio has maintained positive growth rates in both nominal and real terms, and its performance has improved in year-on-year terms for the fifth month running. However, the decline in formal job creation during the health crisis in 2020 could have something of a lagged effect on this portfolio — implying a slowdown from its current performance in the medium term.

Balances through to August this year, appear to confirm the upward trend seen in the consumer and housing portfolios: though the corporate portfolio still seems a long way off reaching positive terrain in either annual or monthly terms. Aggregate contraction was lower than that seen in July and the road to recovery in terms of portfolio growth seems clearer.

The crypto ecosystem and financial stability challenges: IMF

On October 6, 2021, the International Monetary Fund (IMF) published its Global Financial Stability Report, which included a section on cryptocurrencies. The report highlighted that back in 2018, the Financial Stability Board concluded that crypto assets did not pose a material risk to global financial stability. However, this market has changed considerably since the pandemic.

The market capitalization of cryptocurrencies almost tripled between January and May 2021, to reach a record high of USD 2.5 trillion. Subsequently—reflecting the extremely volatile nature of this type of asset—this was followed by a 40.0% fall in their value before rising once again to just above USD 2.0 trillion at the end of the third quarter.

One reason for the rise in market capitalization is increasing investor interest in Stablecoins, which are a class of crypto asset that aims to anchor its value to a specific asset or group of assets. Daily Stablecoin trading volumes stood at around USD 175 billion in May 2021. Their relative price stability compared to other crypto assets (e.g. Bitcoin), along with their use for settlement of spot and derivatives trades in specialized markets, has enabled them to establish their position as the crypto asset with the highest trading volume.

Without doubt, another factor that has attracted investors' attention is the high returns offered by crypto assets. The IMF report makes an interesting comparison in this regard which shows that in terms of risk-adjusted returns (Sharpe ratio) the performance of Bitcoin—and crypto assets in general—is no different to that of other traditional asset classes, such as equity markets.

In fact, over the past year, the risk-adjusted returns on Bitcoin are below those received from US leveraged loans and are around 0.5pp, per unit of risk, above those obtained by the S&P 500. In addition, the report highlights that the diversification benefits of crypto assets are limited. This is not only because their correlation with other asset classes increased significantly during the latest episodes of market stress, but also because it is expected to continue increasing as institutional investors become more involved.

Faced with this growth in the crypto asset ecosystem, the IMF concluded that, at a global level, financial stability risks appear contained for now. However, it recognized that the macroeconomic risks of crypto assets could be significantly higher for some emerging market and developing economies where adoption has progressed fast.

The report distinguishes two factors that could explain crypto adoption: 1) Weak central bank credibility and a vulnerable banking system that may trigger the search for an asset that is a safer store of value; 2) Inefficiencies in payment systems and limited access to financial services.

The report clearly states that the adoption of a crypto asset as the main national currency carries significant risks and is not advisable. Although, for now, the probability of this occurring is low for most countries, the report concludes by highlighting a series of risks resulting from more extensive adoption of Stablecoins among the population, these include: 1) Increased tax evasion and reduced seigniorage; 2) Difficulties in effectively implementing monetary policy; 3) A greater proclivity to capital outflows that affect the foreign exchange market; and 4) More pressure on the banking sector as the crypto assets ecosystem becomes an alternative to bank intermediation. In other words, stronger competition for customer deposits from crypto assets may drive local banks toward less stable and more expensive funding sources to maintain loan growth.

During 2020, there was an increase in wire transfers and correspondent banking, alongside a reduction in the number of branches.

The National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores — CNBV) published the 2021 Annual Financial Inclusion Outlook, with data through year-end 2020. The report presents the progress made in providing the infrastructure to offer financial services, deposit accounts, loans, payment methods and other matters related to financial inclusion.

The number of branches totaled 16,135 at the end of 2020—down 4.4% year-on-year—, with municipal coverage of 50% and demographic coverage of 92%. Of these branches, 75% (12,181) were part of a multiple service bank network, while of the remaining 25%, 2,174 belonged to savings and loan cooperatives (SOCAPS), 1,162 to popular financial companies (SOFIPOS) and 618 to development banking institutions. Mexico City (CDMX) consolidated its position as the state with the most branches (1,828), with Tlaxcala taking last place with a total of 110.

At year-end 2020, there were 46,162 correspondent banks, up 3.3% year-on-year, with municipal coverage of 73% and demographic coverage of 98%. The most frequently undertaken transactions were related to deposits, which accounted for 81% of the total. The state with the most correspondent banks was Mexico (EDOMEX) with 3,833, while Campeche came in last with 337.

The number of ATMs increased in 2020 by 2.5% year-on-year to 59,415, with municipal coverage of 59% and demographic coverage of 95%. By state, similar to the branches, CDMX had the most ATMs (8,522) and Tlaxcala had the least (380). It should be noted that there was an increase of 3% in the number of ATMs where only withdrawals could be made and of 18% in those where only deposits were possible, while there was a fall of 2% in the same period in those ATMs where both services were available.

There were 44,189 transfers per 10,000 adults in 2020, the total amount of which represented 160.2% of GDP. Most of this amount refers to Internet transfers, mainly as interbank transactions, with a total of 43.9 wire transfers per capita during the year. Likewise, the report refers to the correlation between the level of education of the population and the use of digital payment methods. In descending order, the percentage of the population that makes digital payments by level of education was: graduate or higher (42%); upper secondary (20%); secondary (13%); and primary (10%).

Better conditions for the granting of commercial bank mortgages and a change in their destination.

The Bank of Mexico (Banco de México — Banxico) updated its Report on basic indicators of housing loans, with data through March 2021. This report also includes all of the loans given by commercial banks, and those granted by Infonavit, Fovissste and other public bodies. From April 2020 through March 2021, these intermediaries granted 476,000 home loans, 8.8% fewer than in the previous twelve months (April 2019 through March 2020). Infonavit and Fovissste granted 77% of these loans, followed by commercial banks, with a share of 21.3% and by other public bodies with one of 1.7%.

The total granted from this source amounted to MXN 353.4 billion, from April 2020 through March 2021, representing a fall in real terms of 6.9% year-on-year (MXN 362.7 billion granted in the previous year). Of this total, 52.2% came from Infonavit and Fovissste loans, 47.1% from commercial banks and only 0.4% from other public bodies.

The total portfolio of the loans granted by commercial banks amounted to MXN 1.0061 trillion, reflecting real growth of 4.2% from April 2020 through March 2021 (down 7% on the previous year). It is worth noting that the NPL rate of the housing portfolio has deteriorated in the last 24 months — from 2.6% in March 2019 to one of 3.6% in March 2021.

Looking at the comparable loan portfolio[1], it can be seen that in the period April 2020 through March 2021, 109,579 loans were granted for a total of MXN 184.3 billion — an increase of 3.4% in the number of loans and of 6.8% in real terms on the amount of loans granted from April 2019 through March 2020. Also of note was the increase in the number of loans granted for home improvements and repayment of debts (which almost doubled its share of the total loans granted from 6.7% from April 2019 through March 2020 to 13.1% April 2020 through March 2021) and a lower

[1] Refers to the housing loans granted with similar conditions by different financial institutions, which are offered to the general public and for which the terms have not changed since they were initially introduced

percentage used to buy homes, for self-build construction and liquidity (which fell from a share of 93.3% to 86.9% in the period in question).

In relation to the last twelve months for this subgroup of loans (the comparable loan portfolio), the report also recognizes an increase in the average loan amount up to around MXN 1.759 million (a real increase of 3.3%), a longer average term (up from 18 to 19 years) and a lower average weighted interest rate (down from 10.2% to 9.1%).

Auto loans granted by commercial banks fell in real terms, despite better term and interest rate conditions being available.

Banxico updated its Report on basic auto lending indicators, with data through April 2021. For the multiple service bank sector as a whole, last year, the balance of the auto loans granted by banks (15.1% of the total) fell 7.6% in real terms — lower than the contractions seen in other consumer lending segments, like credit cards or personal loans. The auto portfolio NPL rate increased from 2.3% in April 2020 to 3.2% in April 2021, which, despite being the second lowest in the consumer loan portfolio in April 2021, experienced the worst deterioration (90bp) in the previous twelve months.

In the last year, 376,474 auto loans were granted for a total of MXN 80.9 billion, of which 75% were placed by commercial banks and the rest by financial institutions associated with automobile manufacturers. The average amount of the loan from commercial banks was MXN 236,013, some 5% lower than the average amount granted by the financial institutions associated with automobile manufacturers. Despite this difference, traditional banks granted loans with a longer average term (54 vs 51 months) and a lower average interest rate (12.2% vs 13.1%).

2. Financial Markets

Above-forecast corporate earnings releases see risk appetite remain despite price rises

Bottlenecks along the entire global supply chain have led to a shortage of components (e.g. semiconductors) and commodities, significant increases in delivery times of goods and a general rise in prices for both producers and consumers.

This has occurred throughout the year, however, its greater intensity and the expectation that this situation could continue well into 2022, has seen the markets begin to price in a less dovish position by de Federal Reserve. This, bit by bit, begins to put in doubt the main support for the current narrative — the idea that interest rates will remain at low levels for a long period.

The signs that inflation will remain at high levels for longer than anticipated were the main worry of financial market participants in the first half of October. However, higher than expected US corporate earnings removed these fears in the second half of the month and enabled risk asset prices to rise.

A look at **commodity market** prices gives an indication of the magnitude of shortages. The benchmark of this asset class (S&P GSCI) grew 5.5% in October, reflecting a general rise in its main components, with monthly increases in the sub-indices of energy (7.4%), industrial metals (3.6%), agriculture (2.4%) and precious metals (2.2%).

There are also products within these sub-indices with even bigger increases — such as copper, which experienced a price increase of 6.8% in October. It is worth recalling that only a few months ago, the slowdown of the Chinese economy was expected to lead to a fall in the price of various commodities.

In line with expectations of higher prices for longer, **the US yield curve** flattened during October, when a 22bp increase was observed in the 2-year tranche, in response to expectations that the Fed would adopt a more hawkish stance. On the long end of the curve, the 10-year Treasury yield-to-maturity (YTM) increased 6bp to end the month at 1.55%. The lower increase at the long-end of the curve could be consistent with expectations that a stricter monetary policy stance would result in lower inflation in the medium term. As a result, the slope of the US curve tightened 15bp to close October at 1.1%.

In the Mexican fixed income market, higher than expected inflation figures, along with the spike in the US curve, led to a 13bp YTM rise in the 10 year maturity. As a result the 10-year Mbond ended October with a yield of 7.5% — its highest level since the first quarter of 2020.

Despite the movements in the fixed income market, **equity markets** continued their winning streak in October, which occurred over two separate periods. Up to October 13, when corporate earnings releases began to be published, the global stock market benchmark (MSCI World) recorded gains of 1.08%, reflecting an increase of 1.3% in the S&P500, a modest 0.8% in the Nasdaq, 1.2% in the EuroStoxx600 and a rise of 0.6% in the emerging markets benchmark (MSCI EM).

In the second half of October, US stock markets rallied: the S&P500 grew 5.5%—led by tech stock—and the Nasdaq advanced 6.4%. This acceleration was shared to a lesser extent by European markets (Eurostoxx 600 up 3.3%) but not by emerging markets (down 0.4%). The fall in the **CPI** in the second half of the month (-1.0%) was enough for the Mexican stock market index to end October with a slight drop of 0.1%.

Finally, in the **foreign exchange market**, the US dollar had mixed results in October. It depreciated 0.1% against other developed market currencies and appreciated 0.8% against those of emerging markets — affected by the significant depreciation in the Turkish Lira. The Mexican peso appreciated 0.4%, the eleventh most depreciated emerging market currency. The reduction in risk aversion in the second half of the month favored the peso and enabled the exchange rate to end the month below MXN 20.6/USD after having gone as high as MXN 20.9 on October 11.

Recent data and events have made it clear that “transitory” is not the best adjective to describe the current rise in prices. However, current FED communication in the light of last year’s changes to its Monetary Policy Framework, provede the markets some confidence that interest rates can still be kept low for a good while yet.

In such a scenario, investors' attention will be increasingly on the US labor market, particularly in relation to wages, because of their potential impact on inflationary expectations. If these remain high or even rise, the idea that the FED finds itself “behind the curve” could begin to gain ground and the market could further price in a "policy mistake", as it did at the end of 2018.

3. Regulation

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

22.10 Banxico published Circular 7/2021 aimed at credit institutions, brokerage firms, investment funds and investment companies specializing in pension funds, relating to the amendments to Circular 2/2011, with the purpose of increasing the flexibility of the Rules for Government Securities Swaps, to allow the inclusion of any debt instrument issued by the Federal Government. Additionally, it includes the Swap Auction System that allows positions to be presented through the Accountholder Service System (SIAC); it adjusts the terms under which Banxico can authorize other financial institutions to present their positions in auctions; limits the participation of certain institutions when their positions do not comply with sound market practices; includes fixed rate or price auctions, as determined by Banxico; and modifies the formulas for the settlement of government securities.

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