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Banking

Monthly Report on Banking and the Financial System

Iván Martínez Urquijo / Mariana A. Torán / Gerónimo Ugarte Bedwell / Alfonso Gurza / Gabriela López

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1. Banking and the Financial System

Bank deposits slowed down in 2021 following a period of unusual growth driven by the pandemic during 2020

In the fourth quarter of 2021, **traditional bank deposits (demand + term)** registered better-than-expected real growth, bolstered mainly by signals of a change in the trend of term deposits and an increase in demand deposits of the private sector, which remained positive in real terms.

Specifically, quarterly growth in traditional deposits was 2.2% in real terms (4.7% nominal), the highest since the second quarter of 2020 and the largest increase in a fourth quarter since 2016. Demand deposits (67.0% of traditional deposits) grew soundly at 2.7% in the quarter in real terms (5.2% nominal), on the back of the 5.3% rise in demand deposits of the private sector (companies and individuals).

However, the increase in term deposits stands out, with a quarterly increase of 1.2% in real terms (3.6% nominal) in October-December 2021. This was the first quarter to mark a positive real growth rate after five quarters of falls and the third in the last ten quarters. It should be noted that market expectations of rising benchmark interest rates throughout the year, in a context in which analysts expect inflation to start to ease from the second quarter of 2022 onward, appear to have revived the appetite for investment in term deposits.

While it is still early to call a change in the trend marked by term deposits, the increase in interest rates that has already been observed, along with further rises expected, would appear to have significantly raised the opportunity cost of holding funds in liquid assets. This is currently limited to companies, and given the context of economic weakness, it would seem unlikely that the change in trend would be sufficient to significantly raise deposit costs for the banking system in the short term.

Furthermore, in the fourth quarter of 2021 the nominal annual growth of **debt mutual funds** was 1.5%, the first positive annual growth rate since March 2021. In December 2021, the nominal balance of these savings instruments rose by 1.5% year-on-year. A context of higher-than-expected inflation, which brings along expectations of high interest rates in the coming months, does not favor the valuation of the underlying assets of these instruments. However, the change in expectations for global liquidity and federal fund rates may have boosted demand, given the volatility of the financial markets, due to their negative relationship with risk aversion.

At year-end of 2021, bank credit to the non-financial private sector (NFPS) maintained a heterogeneous recovery, and grew 4.9% YoY in nominal figures

In December 2021, the nominal balance of **current loans granted by commercial banks to the NFPS** grew 4.9% year-on-year (-2.3% in real terms). The increase seen in the past two months was not sufficient to offset the falls observed over the rest of the year, putting the average nominal year-on-year variation at -2.9% for 2021.

In December 2021, the current nominal balance of **consumer loans** grew by 5.1% year-on-year (-2.1% in real terms). In the last quarter of the year, the nominal year-on-year change in the balance of consumer loans remained positive, buoyed up partly by higher inflation. The recovery of the different portfolios within this credit segment was uneven and less than one third of the total went back to exhibiting growth in real terms.

While the recovery in official employment figures indicated a return to pre-pandemic levels, household income appears to be lagging behind due to both the creation of lower paid jobs and the loss of purchasing power caused by higher inflation. This trend, which is linked to precautionary factors associated with the different waves of the pandemic in 2021, was reflected in the intermittent and moderate recovery in consumption, which curbed demand for this type of financing.

In December 2021, the current balance of **business loans** grew for the second consecutive month, marking a nominal year-on-year change of 2.7%, which was more robust than the figure for the immediately preceding month (IPM), when nominal growth was 0.1%. In terms of currency, current loans in local currency (78.3% of the total current balance) saw nominal year-on-year growth of 0.9%, the first positive figure in ten months. Balances in foreign currency rose by 8.9%, the second consecutive month of nominal year-on-year growth and the first to see an improvement in real figures.

December was the second consecutive month to show nominal growth, although a sustained improvement in economic activity and confidence indicators would be required in the coming months for this to translate into real growth on a short-term horizon. In contrast, persistent inflationary pressure could undermine the purchasing power of households to the extent that it could cause changes in consumer trends, which would lead to lower corporate income and could have a negative impact on demand for bank financing by companies, exacerbating the effect of the low levels of private investment seen in the past few months.

Lastly, the nominal year-on-year increase in the current balance of **housing loans** was 10.3% (2.7% in real terms). This increase was larger than in the IPM (9.8%) and the figure reported in December 2020 (8.7%). As for other portfolios making up the loans to the NFPS, if inflation remains high for a long period of time, household purchasing power would be affected to the extent that spending trends could be altered. This change toward increased spending on basic goods and services could affect demand for housing credit and impair the performance of this portfolio.

At year-end 2021, the delinquency rate (NPL ratio) stood at 2.5% for all loans to the NFPS, down from the 2.35% registered in November, although much lower than the figure of 2.92% marked in December 2020. By credit portfolio, the NPL ratio was as follows: consumer, 3.21%; housing, 3.24%; and business, 1.91%.

Analysis of the disruptive potential of the crypto-assets market on the financial system: FSB

In line with other international bodies, the Financial Stability Board (FSB), warned in its most recent report of the potential disruptive effect of the crypto-assets market on financial stability.

The main message of the report is to warn that given the fast-evolving nature of the crypto-assets market, a scenario in which they represent a real threat to financial stability is no longer remote. The disruptive capacity of the crypto-assets market is assessed along three dimensions.

The first is the rapid growth in the scale of these markets. At year-end 2021, the capitalization of the crypto-asset market stood at USD 2.6 billion, and while this represents a very small portion of the assets of the global financial system, it should be noted that it increased by 3.5 times during 2021.

The second is its increasing interconnectedness with the traditional financial system. According to this report, systemically important banks and other financial institutions are increasingly willing to play a more active role in, and gain exposures to, crypto-assets as investors or as service providers. The prevalence of more financial products and investment strategies linked to crypto-assets, including through derivatives and leveraged positions, has also increased.

The third dimension refers to the structural vulnerabilities of the crypto-assets market. These include low levels of investor and consumer understanding of how they work, including costs, fees, and resolution mechanisms, among others; uncertainties around the operational resilience of institutions focused on the exchange or investment in crypto-assets; and potential environmental impacts given the energy-intensive consumption of some crypto-assets.

It is important to mention that the scale of the risk represented by crypto-assets is uncertain, as their participants, products and exchange platforms do not operate under regulatory oversight and in some cases do not comply with applicable regulation and law.

Despite the ongoing impact of the pandemic on the economy, the risks to the Mexican financial system remain limited

In February 2022, Banxico published its **Quarterly Report** for 4Q21. Concerning financing terms for the Mexican economy, the report notes that total financing sources underwent a year-on-year change of -0.7% in real terms at year-end 2021. The rise in domestic financing (3.5%) was substantially lower than the figure of 8.3% posted in 2020 and insufficient to offset the 9.0% drop in foreign financing, the largest in the last 12 years.

Domestic financing remained relatively high, reflecting the accumulation of monetary resources driven by the higher demand for liquidity for precautionary reasons. While demand for liquid instruments remains high, more moderate growth was observed compared to the start of the pandemic. Regarding external financing sources, the decrease in government securities held by the foreign sector stands out, which in December 2021 was 31% lower than in February 2020 (nominal figures). As a result, the proportion of government securities held by the foreign sector fell from 29% to 18% in the same period. In contrast, banks, debt mutual funds and the private sector increased their holdings of these types of instruments.

Financial resources in the economy were mainly channeled through the public sector (52% of total flows were taken up by this sector), while flows to the private sector continue to show weakness. In the first case, financing to the public sector registered year-on-year growth of 0.8% in real terms, while the flow of funds to the private sector dropped by 3.9%, marking seven consecutive quarters of decline, although the pace of the fall at year-end 2021 was more moderate than in the previous quarter.

In terms of the stability of the Mexican financial system, the report highlights its solidity, particularly the one of banks, which continue to show capital and liquidity levels that are above minimum regulatory requirements, and, while the risks to the Mexican financial system remain limited, lending has yet to see a strong recovery.

Banxico considers that a key challenge in the future will be maintaining financial stability in a domestic context of stronger lending that is reflected in greater economic growth. Externally, the main challenge for financial stability is the uncertainty associated with the scale of the tightening of global financial conditions, given the adjustments being made to the Fed monetary policy.

In Mexico, total financing fell 3.5% year-on-year in real terms in 3Q21, while financial savings dropped 5.6%

On February 21, 2022, the National Banking and Securities Commission (CNBV) published its **Report on Financial Savings and Financing in Mexico**, with data through September 2021. The report highlights that in 3Q21, total financial savings were down by 5.6% year-on-year in real terms, accounting for 99.2% of GDP. Total financing also fell by 3.5% year-on-year in real terms, for an amount equivalent to 100.6% of GDP.

Foreign savings dropped by 14.9% year-on-year in real terms, accounting for 26.3% of GDP in September. Foreign savings received by the public sector stood at 17.3% of GDP, while private sector deposits accounted for 9.1%. The breakdown as a percentage of GDP shows that securities issued abroad accounted for 12.7%, securities issued in Mexico held by foreign residents accounted for 7.1% and loans obtained abroad accounted for 6.5%, similar, but lower, figures to those seen in the previous quarter.

Domestic financial savings fell by 1.6% year-on-year in real terms in 3Q21, accounting for 72.9% of GDP (compared to 71.7% at the end of June). Holdings of fixed income securities and senior bonds (CBFs, 37.3% of GDP) decreased by 0.3% year-on-year in real terms, while deposits held by financial intermediaries (35.6% of GDP) were down by 3.0%. In this segment, most deposits are held by commercial banks (with a balance equivalent to 23.2% of GDP), followed by Infonavit and development banking, accounting for 5.5% and 3.3% of GDP, respectively.

Foreign financing dropped by 14.2% year-on-year in real terms, accounting for 19.2% of GDP, with financing to the private sector (8.5% of GDP) down by 17.0% in real terms and financing to the public sector (10.6% of GDP) down by 11.9%. By type of foreign financing, fixed income securities issued abroad were the equivalent of 12.7% of GDP, while foreign loans accounted for 6.5% of GDP, in line with the figures reported at the close of 2Q21.

Domestic financing balances dropped by 0.5% year-on-year in real terms, to stand at 81.4% of GDP. The breakdown to September reflects an increase in issues of national debt and senior bonds (46.9% of GDP) of 3.8% year-on-year in real terms, while the total loan portfolio (34.5% of GDP) was down by 5.8%. Financing extended to the private sector (36.6% of GDP) was mainly comprised of commercial banking credit (17.8% of GDP), followed by other financial intermediaries (11.4% of GDP), issues of debt and senior bonds (5.6% of GDP) and development banking (1.8% of GDP). More than 92% of financing extended to the public sector (44.8% of GDP) corresponded to

issues of debt and senior bonds (41.3% of GDP), followed by commercial banking credit (2.2% of GDP), development banking (1.2% of GDP) and other intermediaries (0.02% of GDP).

The decrease in foreign financing led to a reduction of 8.8 percentage points (pp) in total financing as a percentage of GDP, and a shift toward domestic sources. The balance of fixed income securities issued abroad fell by 12.7%, while foreign loans to Mexican creditors dropped by 17.2%. While the components of domestic savings also declined, savings from the rest of the world marked a sharper fall, leading to a shift in balances similar to that seen in the financing segment.

2. Financial markets

A new equilibrium for risk asset prices seems increasingly distant in the face of the war in Ukraine

Geopolitical risks materialized in February, further complicating the search for equilibrium in the financial markets. The commercial impact of Russia's invasion of Ukraine and the economic sanctions applied, added uncertainty to an already volatile environment in which the assumption of protracted low interest rates was removed as inflation took off.

For most of February, financial market participants focused on the size of the first federal fund rate hike in March and the date on which the Fed would start to reduce its balance sheet. In particular, as the January's US inflation print came above expectations and given the more restrictive tone adopted by some members of the Federal Open Market Committee.

However, the economic repercussions of Russia's invasion of Ukraine have brought more uncertainty over the direction and scale of the expectations that guide financial asset prices. First, the further rise in commodities prices has pushed up inflation globally. Although the consensus is still for inflation to peak shortly, this could take longer to be observed.

The global commodities benchmark (SPGSCI) gained 7.9% in February in the wake of the rises marked by all its components. Standouts included the 8.3% monthly increase in the energy sub-index and the 7.7% monthly rise in the agricultural prices subindex (Chart 1), given the importance of Russia and Ukraine as grain, oil and gas producers. The Brent oil price rose by 10.7% in February and wheat futures increased by 21.9%.

Furthermore, the search for safe-haven assets after the invasion has led to a **generalized fall in interest rates**. The potential consequences on confidence and economic activity caused by the conflict itself and the sanctions imposed by the West triggered a fall of 17 basis points (bp) in the YTM of the 10Y Treasury bond in the space of only four days. Consequently, it closed February at 1.83%, barely 5 bp higher than at the end of January (Chart 1).

The YTM of the 2Y Treasury bond also fell by 17 bp following the invasion of Ukraine between February 23 and 28, the latter after a 42 bp rise at the start of the month influenced by expectations of the kick-off of rate hikes. At the end of February, the futures market ruled out the possibility of a 50 bp rise in March, although it maintains its expectation for a c.125 bp hike in the federal fund rate in 2022.

Therefore, the slope (2-10Y) of the U.S. curve stood at 39 bp at the close of February, the lowest since April 2020. This decline reflects some concerns regarding the potential effects that current events could have on economic growth and the 9 bp reduction in the real 10Y interest rate in the United States, which ended February at –0.8%.

Thus, **the Fed now faces a more complex scenario with higher inflationary pressures and some downside risk for growth** in a context in which lower long-term rates could make it more difficult to tighten financial conditions impairing the monetary policy transmission. Under these circumstances, the measures to reduce its balance sheet by around USD 9 trillion will be at least as relevant for the markets as the increase in interest rates.

These reductions in nominal and real long-term interest rates along with expectations of some market participants that the war would be short-lived, led to gains **on the U.S. stock markets** toward the end of February.

Between February 23 and 28, the S&P500 rose by 3.5%, the Nasdaq was up 5.5% and the Russell 2000 was up 5.3%, outstripping the 2.4% gain by the world stock market benchmark (MSCI World). In Europe, the greater impact of the war led the Euro Stoxx 600 to post a loss of 0.17% in the same period.

However, despite the gains observed at the end of February, the capital losses resulting from higher interest rate expectations for most of the month led the U.S. stock markets to close with losses (Chart 1) for the second month in a row.

The invasion of Ukraine caused a negative performance of the main **Mexican financial assets** at the end of February.

The search for safe-haven assets triggered a sale of fixed rate bonds and hence the YTM of the **10Y Mbono** increased by 8 bp between February 23 and 28, and by 27 bp for the whole month of February (Chart 1). It closed at 7.95% in the month, the highest level since the start of the pandemic.

The **Mexican peso** depreciated by 1.1% between February 23 and 28 on the back of the widespread demand for dollars in the markets. This depreciation was not greater than the appreciation of 1.9% observed in previous weeks and therefore the peso ended February with an appreciation of 0.8% (Chart 1), the fifth largest rise among emerging market (EM) currencies. This put the exchange rate at 20.47ppd at the close of the second month.

It should be noted that despite the risk aversion, some EM currencies were boosted by their country's status as an exporter of commodities. This was the case of the Brazilian real.

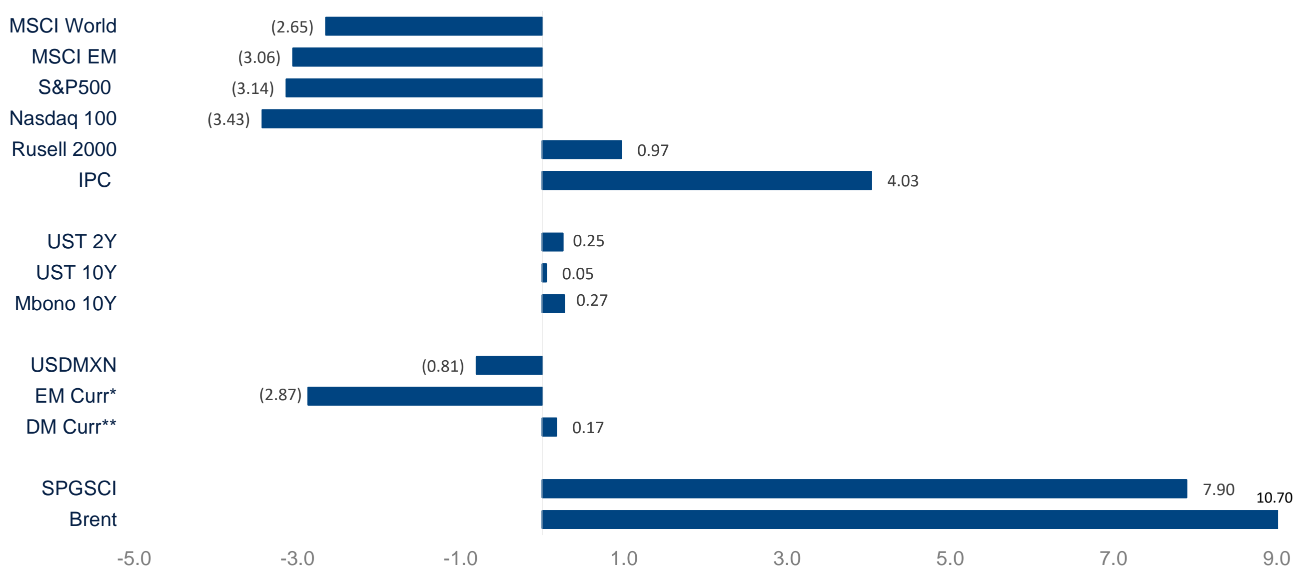
Given that the outlook was already complex due to high global inflation, the war between Russia and Ukraine **has made it even more difficult to find a new equilibrium for risk asset prices**.

The balance of inflation risks and economic growth for central banks is more uncertain, which makes it extremely difficult to channel the expectations of market participants, which will have an adverse effect on volatility.

This situation has been exacerbated by the fact that the war is no longer expected to be short-lived and an increasing number of sanctions are being imposed to force the Russian government to withdraw or trigger a movement inside Russia to unseat its leader.

Therefore, the scenarios that factor in a prolonged conflict or even an escalation involving other nations are starting to become more probable, and consequently, the likelihood of stagflation and the sense that risk aversion could increase in the coming weeks.

Chart 1. **CHANGE IN THE PRICES OF MAIN FINANCIAL ASSETS, FEBRUARY 2022**
(% CHG IN LOCAL CURRENCY)



*JP Morgan Emerging Markets Currency Index. For this index, a reduction (increase) implies a depreciation (appreciation) of a basket of emerging market currencies against the USD. **DXY Index. For this index, a reduction (increase) implies a depreciation (appreciation) of the USD against a basket of developed market currencies.
Source: BBVA Research based on Bloomberg data.

3. Regulation

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

16.02 **Draft reform of the Credit Institutions' Law**

The purpose of the reform is to ensure that the natural and legal persons included on the Restricted Persons list have the right to be heard. It assigns credit institutions the responsibility of informing individuals that they have been included on this list.

The draft reform was approved with amendments by the Senate and sent to the Chamber of Deputies from where it will be passed on to the Executive for publication in the DOF.

Publications in the DOF

01.03 **Resolution amending the general provisions on liquidity requirements for commercial banking institutions.** The resolution allows credit institutions to exclude the variations observed in March 2020 in the calculation of contingent outflow related to transactions with derivative financial instruments (*Look Back Approach*), and for establishing the eligibility of the securities that can be used as Group level II liquid assets. This is in line with the exemptions to the "General provisions for liquidity requirements for commercial banking institutions" that were published on April 14, 2020 to address the pandemic.

Also, the terminology used in the "General provisions for credit institutions" amended through the Resolution published in the DOF on March 13, 2020, has also been standardized to update the accounting criteria under IFRS 9.

03.03 **Resolution that reforms and adds to the General provisions referred to in article 115 of the Credit Institutions' Law.** This allows credit institutions to open level II accounts for refugees and repatriated Mexicans, through documents accrediting their legal status.

It includes prepaid cards in national currency for foreigners, requiring banks offering these cards to establish mechanisms to monitor their purchases and the topping up of funds.

It also enables credit institutions to share information, through a platform, with regard to: (i) prior history or known activity of customers and users; (ii) statistical data about their customers and users from unusual transaction reports and 24 hour reports; (iii) reports on internal operations of concern, and (iv) circumstances taken into account when reporting the unusual transactions or operations of concern.

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ENQUIRIES TO:
BBVA Research – BBVA: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
bbvaresearch@bbva.com www.bbvaresearch.com