Banking

Monthly Report on Banking and the Financial System

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1. Banking and Financial System

Traditional deposits recovered dynamism in February, driven by corporate demand deposits.

In February 2022, the balance of traditional bank deposits (demand + term deposits) registered a nominal annual growth rate of 6.8%, maintaining levels above 5.0% for the third consecutive month, which has allowed the fall in real terms of these balances to abate. In particular, since March 2021, traditional deposits began to register contractions at an annual real rate, which peaked in April 2021 (-7.5%) and have gradually tapered off since (-0.4% in February 2022). However, the gradual recovery of demand deposits (whose balances grew 4.2% in real terms in February) was still not enough to offset the ongoing slowdown in the balances of term deposits (with a fall of -8.9% in real terms in the second month of the year) which has already lasted 19 months.

Demand deposits reached a nominal annual growth rate of 11.8%. This dynamism includes 7.6 pp associated with inflation; in other words, 60% of the observed growth is explained by an accounting effect. Even when taking this effect out of the equation, demand deposits showed a significant recovery in February, doubling the annual real rate observed in the last three months (4.2% vs. 2.1% on average).

The deposits that most contributed to this greater dynamism were the demand deposits of companies and individuals, which reached real growth rates of 9.2% and 5.2% (17.1% and 12.9% nominal, respectively). In the first case, the relative improvement (compared to 2021) in the revenue of goods and services companies could explain the observed growth, although this would be a base effect, since one of the most severe waves of the pandemic was recorded in the first months of 2021. In the case of demand deposits of individuals, growth could be associated with the recovery of formal employment. Moreover, for both companies and individuals, part of the increase in demand deposits could also reflect the reallocation of resources from term deposits to more liquid instruments.

Term deposits continue to show weakness. In February 2022, these savings instruments showed a nominal contraction of -2.3%, a variation made up of a real contraction of -8.9 pp, and an inflationary effect that partially moderated this fall, contributing 6.7 pp to its performance. All sectors holding this type of savings (companies, individuals, other financial intermediaries and the non-financial public sector) reduced their balances with respect to the previous year. This indicates that the incentive of a higher nominal interest rate has not been sufficient to increase the attractiveness of term deposits within a setting of higher inflation. Additionally, this environment could be generating a greater need for liquid resources for agents to finance their current expenditure, thus favoring the growth of demand deposits.

Private sector credit halted its recovery in real terms, held back by the lack of dynamism in business credit.

In February 2022, the outstanding credit portfolio balance granted by commercial banks to the non-financial private sector (NFPS) grew by 5.3% in nominal terms, a result which, although slightly above the rate recorded the previous month (5.1%), does not represent an improvement in real terms, given that after discounting the effect of inflation, the contraction observed in February of -1.8% is equal to that recorded in the first month of the year. Business loans contributed -2.9 pp to the fall recorded in February, a decrease that was partially offset by the contribution of the consumer and housing portfolios (0.4 pp and 0.9 pp, respectively).

Consumer credit achieved a real annual growth rate of 2.0% (9.5% nominal), maintaining its momentum in positive territory for the second consecutive month. The more stable recovery of private consumption and formal employment have favored the reactivation of demand for this type of credit. The credit card and payroll loans segments (63% of the consumer portfolio) drove the recovery, with a real growth of 1.7% and 3.1%, respectively, while personal loans and loans for the acquisition of consumer durables (ACDs) continued to register contractions in real terms (1.7% and 0.5%, respectively).

The housing portfolio registered positive growth rates in nominal and real terms in February (10.6% and 3.1%, respectively). Although the real performance recorded in the first two months of the year represented an improvement compared to the immediately preceding two-month period (3.1 vs. 2.5% average), it is below the performance observed in the same period of 2021 (4.7% on average Jan-Feb 2021). Although the housing portfolio is the only one that has managed to maintain its real growth throughout the pandemic, it has shown signs of slowdown, which could become more pronounced if the increase in interest rates is mirrored in long-term financing costs or if persistent inflation begins to negatively affect the ability to pay of households.

Lastly, business lending (55.2% of the total portfolio to the NFPS) interrupted its recovery, registering a fall in real terms of -5.2%, higher than the contraction observed in the previous month (-4.6%) and slightly lower than the -5.9% recorded in February 2021. The weakness still observed in the recovery in private investment and the increase in the cost of financing may explain the slower recovery of this credit segment.

The Mexican financial system could face increased risk aversion.

The Financial System Stability Board (CESF for its acronym in Spanish) updated its balance of risks assessment. According to its press release, at its last session, the CESF analyzed the current challenges, when there is a combination of the remaining pressures associated with the pandemic and the emerging ones relating to the geopolitical situation between Russia and Ukraine.

Among the global risks to financial stability, the press release highlights greater risk aversion associated with the recent geopolitical conflict and the tightening of financial conditions as a result of a more accelerated normalization of monetary policy at a global level, in an environment of economic slowdown and significant inflationary pressures. With respect to domestic risks, although economic activity in Mexico is beginning to recover, the risk of further weakness in domestic consumption and investment remains, as well as adverse effects on sovereign and Pemex credit ratings.

Against this backdrop, the banking and insurance sector maintains a solid position, and the press release highlights that the capital and liquidity levels of commercial banks would allow for a prudent expansion of credit, which has not fully recovered its dynamism. Meanwhile, the risk indicators of other non-bank financial intermediaries remain at

moderate levels and, given their small participation in the system as a whole, do not represent a potentially systemic risk.

Covid-19 and credit risk: challenges for banking and the outlook of the supervisors.

The Bank for International Settlements (BIS) published a newsletter addressing issues related to credit risk. In the wake of the Covid-19 pandemic, banking institutions around the world have faced challenges in assessing the credit quality of their customers, while supervisors have observed a variety of policies and practices in terms of governance and models associated with credit risk.

Credit risk has been a major focus of the Basel Committee on Banking Supervision (the Committee), as this is the main risk faced by most banks. Poor credit risk management and failures to identify portfolio deterioration in a timely manner can lead to losses for banks, as well as undermine confidence in the banking sector.

The unprecedented nature of the crisis triggered by the pandemic and the unparalleled response of public sector support to address it has exposed a number of issues that require attention. In particular, the Committee notes that supervisors remain concerned about the residual effect of the support measures, which could be masking the real risk conditions and the high levels of indebtedness of some borrowers, and may affect the perception of their future ability to pay.

At the same time, the supervisors remain wary of the provisioning practices of banking institutions, as given the magnitude of government support in some countries, concerns prevail as to whether provisions are adequately reflecting the incurred risks.

It is also noteworthy that banks have remained actively involved in the evolution of the pandemic and the measures to address it, with risk appetite frameworks that have operated robustly and where the segregation of duties in the credit process has been largely maintained. However, significant challenges remain in assessing the probability of default and incorporating public support measures into data and reporting.

Lastly, the Committee notes that banks have applied significant opinion adjustments to their internal ratings and provisioning models, reflecting the uncertain and atypical environment generated by the pandemic. In light of this, the Committee believes that banks should improve the control and governance of these models. To this end, institutions and supervisors are still considering how to better incorporate and reflect the effects of the pandemic in their respective credit risk models, given the nature of the crisis and its impact on historical trends and correlations.

Lending contracted in almost all regions of the country in 4Q21.

According to the Regional Economic Report of Banco de México[1], and based on the Credit Market Survey (EECMC for its acronym in Spanish), during 4Q21 the percentage of companies that used commercial banks as a source of financing reached 33.9%, as a result of the annual growth in all regions, with an increase of 6.9% nationwide, mainly to the detriment of supplier credit, which fell 16.2%. By regions, the percentages of companies that used commercial bank credit were: North, 37.0%; Central, 35.0%; North Central, 34.8%; and South, 23.5%. However, compared to 3Q21, the percentage that resorted to bank financing showed a decrease of 2.2% nationwide, with the largest drop in the North Central region (-8.4%), followed by the Central (-3.8%), while the North (2.6%) and the South (3.6%) registered a quarterly increase. The percentage of companies that obtained financing through suppliers showed annual declines in all regions except the South, while in quarterly terms, the contraction was generalized.

The outstanding portfolio of non-financial private companies in commercial banks presented a real annual contraction[2] of 4.6% in 4Q21, the sixth consecutive quarter of decline in annual terms. Since 4Q19, the shares of outstanding balances have shown a recomposition by region. The Central region went from a 57.6% share in 4Q19 to 54.0% at the end of 2021. The share of the North, North Central and South regions increased, mainly as a result of the composition effect due to the greater downturns registered in the Central region during 2021, closing the year with shares of 22.0%, 17.0% and 7.0%, respectively.

By activity type, the trend in the outstanding loan portfolio in 4Q21 showed significant divergences. The agricultural sector presented an increase in the South and North Central regions, with a year-on-year real growth of 1.0% and 2.1%, respectively. Conversely, the outstanding balances of primary activities registered negative growth in the North (-0.3%) and the Central (-7.4%). The outstanding portfolio of the industry sector increased in the North region (3.5%), and fell in the South (-10.7%), Central (-9.4%) and North Central (-5.5%) regions. The services sectors showed an increase in outstanding balances of 1.5% in the North Central region of the country, while declines occurred in the Central (-6.8%), South (-3.1%) and North (-1.0%) regions.

According to our analysis and taking into account that the recovery of the entities and regions depends directly on the sectoral composition of gross value added, given a scenario of intermittent recovery of private consumption we would expect that financing for commercial activities would be affected, having an impact on the regions with the highest population concentration.

In addition, lower investment expectations, coupled with the persistence of bottlenecks in supply chains, would impact the business portfolio as a whole and, more significantly, industrial financing. This implies that a period of sustained growth in the business portfolio in real terms may still be delayed.

1: Regionalization in the report: North includes Baja California, Chihuahua, Coahuila, Nuevo León, Sonora and Tamaulipas; North Central includes Aguascalientes, Baja California Sur, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas; Central is made up of Mexico City, Mexico State, Guanajuato, Hidalgo, Morelos, Puebla, Querétaro and Tlaxcala; and South, Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán.
2: It should be noted that the actual variation takes into account inflationary effects, but not exchange rate effects.

2. Financial Markets

The invasion of Ukraine and the restrictive tone of the Fed intensified volatility in financial markets.

The outbreak of the war in Ukraine and expectations about the speed of the monetary tightening cycle in the U.S. remained the main factors behind the movements of the financial markets during March. In a context of high global inflation, the communication of the Federal Reserve and the changing positions of the main players in the war conflict, influenced variations in risk aversion that outlined two stages for the prices of most asset classes in March.

During the first half of the month, once the idea of a short-lived conflict had dissipated, the consequences on growth expectations and commodity prices stemming from the conflict itself and from the sanctions imposed on Russia, prolonged the episode of risk aversion that began at the end of February with the start of the Russian occupation.

In view of the higher inflation expectations and interest rate increases, there was a sell-off of **fixed income** assets. Interest rates increased significantly along the entire Treasury bond curve, with a greater intensity at the short end. This brought the yield to maturity of the 2-year bond to 1.85% (see graph 1), higher than the yield on the 10-year bond at the end of February (1.83%).

The sell-off in Mexican government bonds was even more pronounced. The yield to maturity of the 10-year bond of rose 68 basis points (bp) in the first two weeks of March, which led it to trade at 8.64%, higher than the level recorded in March 2020.

Influenced by interest rate hikes and risk aversion, the main **stock indexes** registered losses during the first half of the month (see graph 1), led by the Russian market, which dragged the emerging markets *benchmark* (MSCI EM) down by double digits (-12.3%).

For stock markets in Europe and the U.S., falls ranged between 2.5 and 5.8%, with the Nasdaq falling more sharply in light of the expectation that further interest rate hikes could have a more pronounced effect on the valuations of companies with expected cash flows concentrated in the long term.

In the **foreign exchange market**, the dollar strengthened across the board during the first two weeks of March, leading to a 1.7% depreciation of the Mexican peso, which pushed the exchange rate to levels of 20.83 pesos per dollar (ppd). This depreciation of the peso was higher than the 1.6% depreciation of the emerging currencies *benchmark* against the dollar (see graph 1).

For the second half of the month, the more restrictive tone of the Fed Chairman but mostly the optimism regarding a possible peace agreement in Ukraine changed the behavior of market participants.

Stock markets were initially bolstered by one of the messages of the Fed Chairman at his March 16 conference, in the sense that the U.S. labor market and economic activity could remain buoyant despite the interest rate hike cycle. Then, although this message was overshadowed by a more restrictive tone from the Fed Chairman a few days later, the start of negotiations between Ukraine and Russia sparked optimism and an appetite for risk.

All the main stock indexes recorded gains between March 16 and 31. These gains were of such magnitude that in most cases they managed to recoup the losses of the first fifteen days of the month (see graph 1).

Given the increase in commodity prices, the stock markets of producing economies registered a positive differentiation. The emerging countries *benchmark* rose 11.2% in the second half of March, while the CPI of the Mexican Stock Exchange increased 6.7% to reach a new all-time high at the end of the month.

Unlike the equity market, the more restrictive tone of the FED Chairman prevailed in the US **fixed-income markets** and interest rates continued to rise. The yield to maturity of the 2-year Treasury bond increased an additional 42bp and closed the month at 2.33%, practically the same level as the yield of the 10-year bond (2.34%), which reignited comments about a possible recession (see graph 1).

A heightened appetite for risk and increased commodity prices led to a generalized depreciation of the dollar in the second half of the month. In particular, the currencies of grain and oil-producing countries recorded significant appreciations, with the EM currency *benchmark* appreciating 4.9% against the dollar in the referred to period.

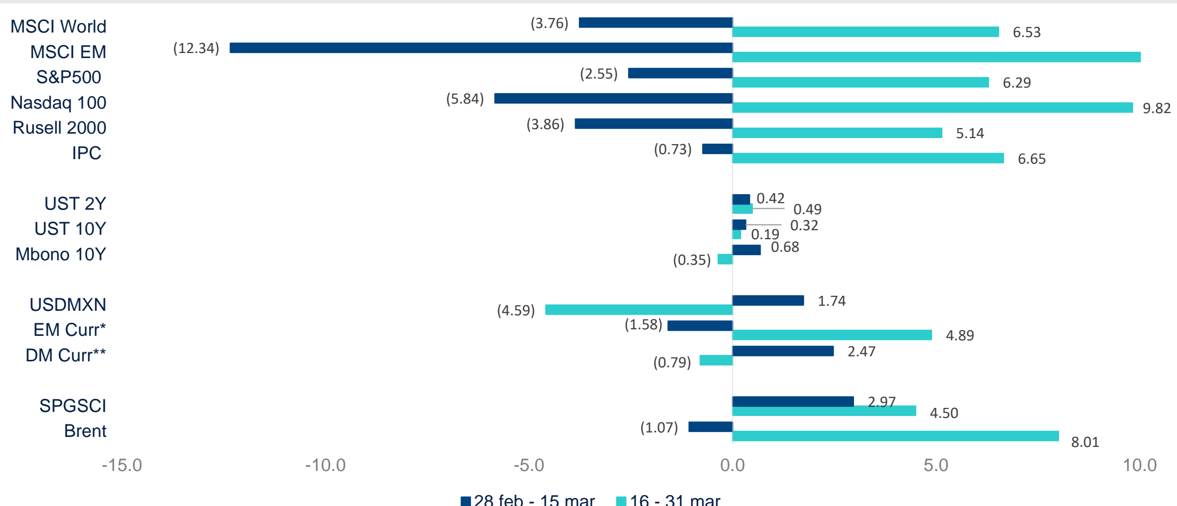
A 4.6% appreciation of the Mexican currency in the second half of March allowed the exchange rate to close the third month of the year below 19.90 ppd.

As previously mentioned, the underlying backdrop to these movements continues to be that of high inflation and the rally on **commodities** continues to contribute to this scenario. During the month of March there was another generalized rise in the components of the commodities *benchmark* (SPGSCI), although energy and agricultural products continue to stand out, given their connection to the armed conflict (see graph 1).

In the coming weeks, it seems unlikely that the main factors influencing markets will dissipate or change significantly. However, the actions of the Fed to reduce its balance sheet (*Quantitative Tightening*) have the potential to add a high degree of uncertainty to price movements.

While debt and equity markets already reflect the expectation of the restrictive approach of the Fed, the consequences of the changes in the credit markets will have to be observed in light of the departure of one of the main borrowers in the last few years.

Chart 1. **PERFORMANCE OF MAJOR FINANCIAL ASSET PRICES, MARCH 2022** (% VARIATION IN LOCAL CURRENCY)



*JP Morgan Emerging Markets Currency Index. For this index, a decrease (increase) implies a depreciation (appreciation) of a basket of emerging economies currencies against the USD. **DXY Index, for this index a decrease (increase) implies a depreciation (appreciation) of the USD against a basket of developed count currencies.
Source: BBVA Research, information from Bloomberg.

3. Regulation

Publications in the DOF (Official Journal of the Federation).

Circular **1/2022 Interbank Electronic Payment System (SPEI, for its acronym in Spanish). Amendments to Circular 14/2017.** Major changes are introduced to the SPEI architecture with the inclusion of Indirect Participants (and their customers) whose access to the system will be provided through existing participants (now "Direct Participants"). This applies to both electronic money transfers and CoDi transactions. The use of cell phone numbers, linked to accounts, is also envisaged for these transfers.

Circular **2/2022 Interbank Payment System in US Dollars (SPID, for its acronym in Spanish). Amendments to Circular 4/2016. (Miscellaneous)** Replaces the reference to Article 189 of the CUB, repealed in 2018, reinstating the independence requirements that were previously established for external auditors.

Circular **3/2022 Payment systems managed by Banxico. Amendments to Circular 13/2017**. Implements changes to the indirect participation in SPEI with respect to the obligations of the Participants.

Circular **4/2022 Operations of credit institutions, regulated multiple purpose financial companies that maintain equity links with credit institutions and the National Agricultural, Livestock, Forestry and Fisheries Development Financial Institution**. **Amendments to Circular 3/2012.** Implements schemes that allow transfers to be sent using only the ten digits of cell phone numbers, and establishes that credit institutions facing events that affect the execution of electronic funds transfers must notify their customers within 60 seconds, either that the event was generated in their own infrastructure or, if applicable, that an event occurred that affected the regular operation of SPEI.

Circular **5/2022 aimed at Entities Subject to Supervision by the Banco de México.** Amendments to the exemptions and interim measures in relation to the COVID-19 pandemic, ending the period of suspension of regular visits.

Circular **6/2022 aimed at Financial Institutions and Financial Intermediaries Subject to Regulation and Supervision by the Banco de México. Amendments to Circular 13/2012.** Broadens the legal acts that can be carried out through the Electronic Support Module for automated procedures for the exchange of information and communications with the Entities, and also allows the resolutions and procedures relating to appeals for review and revocation to be known, presented and consulted through this system.

Projects under review.

18.03 **Resolution amending the general provisions applicable to credit institutions**

The parameters for determining Loss Severity for models based on internal ratings with a basic approach for the commercial portfolio are changed from fixed percentages for senior unsecured and subordinated positions (currently 45% and 75%, respectively) to a scheme based on the months elapsed since the classification of the position in Stage 3, increasing the risk sensitivity of the variable.

In addition, the requirements for using internal models to determine the stability of deposits for market risk capitalization purposes have been adjusted. Accordingly, the sensitivity analysis of the stability of deposit balances to movements in the market rate (Cetes 28), or to other variables such as the interest rate spread or to "changes in structural factors, measured by economic activity indicators, among others", is included in the sensitivity analysis; likewise, the characteristics of the backtesting of the aforementioned model are detailed.

08.03 **Resolution amending the general provisions applicable to credit institutions**

Revises the calculation of the capital requirement for the exposure resulting from contributions to a central counterparty default fund for the settlement of derivative transactions, aligning it with international standards in this area.

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