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Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

Traditional bank deposits continued to grow at an annual rate, supported by demand deposits and a lesser decline of term deposits.

In May 2022, the balance of traditional bank deposits (demand + term) registered a real annual growth rate of 1.9% (9.7% nominal), accumulating three consecutive months of growth. Demand deposits continue to boost traditional deposits, and in May contributed 2.4 percentage points (pp) to their growth, but this was partially offset by the -0.6 pp drop recorded for term deposits, which are gradually curtailing their decline.

Demand deposits registered a real annual growth rate of 3.7% (11.6% nominal), in line with the average observed between January and April of this year. The holders that most contributed to the annual growth recorded in May were companies and individuals, whose demand deposits registered a real annual change of 6.1% and 5.0%, respectively, a trend that was reflected in a contribution of 1.5 pp each to total growth.

Although the reactivation of household spending has been reflected in a greater flow of revenue for companies, the aggregate balance of non-financial private sector (NFPS) deposits still reflects the liquidity accumulated throughout the pandemic, associated with both the restrictions on mobility that limited household consumption and the accumulation of resources for precautionary reasons. In constant pesos, in May 2022, the balance of non-financial private sector deposits was still 23% higher than the balance reported in February 2020. The greater momentum registered in private consumption (8.6% growth in the first quarter of 2022 (1Q22) vs. -5.3% in 1Q21), has been counterbalanced by a favorable performance of some sources of revenue (such as formal employment and remittances), allowing a balanced inflow and outflow of resources in demand accounts.

Term deposits, meanwhile, continue to slow their decline. In May 2021, these savings instruments showed a real contraction of -1.7% (nominal growth of 5.8%), half the drop recorded in the previous month (-3.4%). In monthly terms, the balance of this type of deposits continues to show an initial recovery, reaching a real growth rate of 0.4%. Among the sectors holding this type of savings, individuals registered a real annual growth rate of 1.0%, the first positive variation after 32 consecutive months of declines. Although this recovery is not yet sufficient to offset the annual rate of decline still observed in the balances for companies, the non-financial public sector, and other financial intermediaries, it could be a first sign of recovery for this type of savings instrument.

For the first month since March 2020, all bank loan portfolios for the non-financial private sector (NFPS) grew in real terms in May

During May 2022, the nominal balance of the performing loan portfolio granted by commercial banking to the NFPS grew 10.2% annually. Although inflation accounts for 7.9 percentage points (pp) of this dynamism, the 2.3% real annual increase was the result of a real growth of balances in all the portfolios that make up this type of financing, a phenomenon not recorded since February 2020. The corporate portfolio, lagging behind in its recovery with respect to household credit, registered a real growth of 1.1%, its first since August 2020, when the use of credit lines by companies during the first months of the pandemic was still being reflected.

By credit aggregates that make up the country's NFPS, the annual nominal variations were: consumption, 12.5% (4.5% real); housing, 11.4% (3.5% real); and businesses, 8.8% (1.1% real). In May-22, the contributions to the 10.2 pp growth of bank credit to the NFPS were (in descending order): businesses, 5.0 pp; consumption, 2.6 pp; and housing, 2.6 pp.

During May 2022, the appreciation of the peso in year-on-year terms mitigated the increase in the outstanding nominal balances of the corporate portfolio in foreign currency. Expressed in pesos, this portfolio presented a nominal variation of 8.5% (5.6% in the immediately preceding month (IPM) and -27.8% in May 2021), which in dollars is equivalent to 9.8% (4.6% in the IPM and -19.7% in May 2021). Nominal outstanding balances in domestic currency increased 8.9% in May (after having registered increases of 6.6% in the IPM and a contraction of -8.7% in May 2021), continuing with the trend of expansion in annual terms of this portfolio, after the contractions registered up to November last year.

Although this growth confirms the trend of recovery of financing by commercial banking to the NFPS, the use of credit to finance current spending (whether by households or companies) does not imply *per se* a sustained momentum in the long term. This will require an improvement in economic activity indicators, which will increase disposable income in the economy, together with greater confidence that will encourage investment projects. Under these assumptions, the possibility of observing a sustained growth in demand for credit and, potentially, a persistence in the growth of balances, would increase.

The lingering effects of the pandemic and the combination of supply and demand factors pose new challenges to the stability of the financial system

The Bank of Mexico (Banxico) published its "Financial Stability Report" (FSR) for the first half of 2022 (1H22), which highlights that, in addition to the challenges associated with the lingering effects of the pandemic, there are also those associated with the geopolitical conflict between Russia and Ukraine, global inflationary pressures, and the tightening of financial conditions, while the probability of potential increases in risk premiums, both sovereign and Pemex, and possible effects on their credit ratings still persist.

Stress tests confirm the resilience of the financial system to potential credit, liquidity, and climate change shocks. Although the Mexican financial system maintains a solid position, with capital and liquidity levels for commercial banks that comfortably comply with regulatory minimums, the granting of credit has not yet achieved the robust and generalized reactivation that tends to follow and eventually boost economic growth.

Our analysis of this report leads us to share some of its main conclusions. In particular, we agree with the claim that commercial banking has managed to maintain an outstanding resilience and solidity, given the magnitude of the shock associated with the pandemic and the current situation, with the risks that this entails.

Regarding the performance of financing, we agree with the perception of the slow recovery that can be observed, mainly in the race of non-financial private companies. In the case of commercial banking consumer credit, although it has shown a more vigorous recovery, the risk persists that the intermittent recovery of private consumption could negatively affect the performance of this type of financing, especially in light of a scenario of weak domestic demand, potentially aggravated by a decrease in income resulting from impacts on the labor market. As for the recovery of the corporate portfolio, we agree with a less optimistic outlook, resulting from a potential persistence of the lethargy observed in the private investment area.

It should also be noted that the commercial banking sector has maintained low delinquency rates, and even the rates for the consumer portfolio are below pre-pandemic levels. Although part of this improvement is associated with the application of IFRS 9 criteria, this reduction was already observed prior to implementation, as in the case of the housing portfolio, which reflects the banks' capacity to address these impairment losses through the creation of reserves. It is therefore important that this mechanism be improved as a result of the more appropriate recognition of credit risks under IFRS 9 accounting criteria.

Outstanding balances contracted in the Center and South of the country in 1Q22 due to the drop in financing for secondary and tertiary activities

According to Banco de México's Report on Regional Economies[1] and based on the Survey on the Conjunctural Evaluation of the Credit Market (EECMC), the outstanding portfolio of non-financial private companies in commercial banking presented a real[2] annual decrease of 3.4% in 1Q22, a softening of the contractionary trend registered during 2021, a year in which corporate financing fell 13.0% on average.

Bank financing in the Central region, which accounts for 54% of credit, contributed -3.3 of these -3.4 percentage points (pp), while -0.3 pp can be attributed to the Southern region of the country, 0.1 pp to the North-Central region, and 0.1 to the Southern region.

During 1Q22, with respect to the performing loan portfolio by type of activity, the agricultural sector presented a contraction only in the Central region of the country, with a real annual rate of -8.3%. By contrast, the performing loan portfolio for primary activities in the South grew 6.9%, while in the North and North Central regions, the growth rates

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 real change does not consider exchange rate effects.

were 6.1% and 2.1%, respectively. In the case of industry, the largest drop occurred in the Southern region, with a real annual change of -11.6%, followed by the Central (-8.7%) and North Central (-2.4%) regions. The North registered real growth of 0.8%. As for services, the Central region experienced the largest real annual contraction (-3.9%), followed by the South (-1.3%) and North (-0.5%) regions. The outstanding portfolio for tertiary activities in the North Central region was 1.9%.

According to our analysis, although total corporate credit already reached positive real growth rates in May-22, the regionalization of credit dynamics allows us to observe a heterogeneous pattern of recovery by region and sector.

The recovery of activity and the promotion of investment in certain activities has meant that contractions are still being registered in various areas of the country, depending, to a large extent, on the sectoral mix in the entities that make up each region and on regional incentives to reactivate investment flows.

2. Financial Markets

Risk asset prices during the first half of the year were dominated by inflation and its consequences

The debate over the peak in US inflation in April proved to be premature, as expected. The May inflation figure was above 8.6% and again higher than anticipated. As a result, expectations of a tighter monetary cycle increased and, with it, greater concerns about a recession in the US economy.

Thus, the first half of the year ended with an unusual confluence of geopolitical events and economic shocks that have made inflation the central theme and catalyst for significant losses in the financial markets.

The unusual circumstances make it difficult to find an entirely valid historical reference, which has meant that market participants' expectations have not found their footing over the last few months, and this has been reflected in the continued volatility of most of the financial variables.

The most salient developments in the financial markets during the first six months of the year can be summarized as follows: a significant increase in commodity prices; generalized interest rate hikes in response to rising and persistent global inflation; declines not seen in several decades in the main stock indexes; and an appreciation of the US dollar.

Losses in global equity markets during the first half of the year were widespread, although of greater magnitude for US indices (see graph 1), which had benefited from their high exposure to the technology sector during the pandemic. For the global equity benchmark (MSCI World), the first half drop was 21.2%, whereas for the S&P500 it was 20.6% and for the Nasdaq it was 29.5%.

At more moderate levels, the fall of the emerging economies equity benchmark (MSCI EM) was 18.8% during the first six months of the year, while the Mexican Stock Index suffered a reduction in its price of 10.8%. This smaller fall can be explained by the absence of technology companies whose fall has been greater after the rise in rates, by the presence of some companies linked to the production of raw materials and by lower valuations.

These losses in the stock markets were strongly influenced by the generalized increase in interest rates. For the US curve, the increases were more than 200bp for the short end, with greater association with the federal funds rate, and 150bp for the 10-year curve during the first half of 2022 (see graph 1). As a result, the drop in the benchmark price of this asset class reached 9.2% for the period.

In Mexico, the yield to maturity of the 10-year bond increased 150bp in the first half of the year, to close June at 9.05%, slightly lower than its peak of 9.22% reached on June 16.

As mentioned above, the catalyst for part of this movement was the rise in commodity prices. This is clearly shown by the fact that during the first half of the year, the benchmark of this asset class (SPGSCI) had increased by 26.4%. Energy prices increased 46.5% during the period, while food prices decreased during June (-12.3%) to close the quarter with an increase of 6.1% (see graph 1).

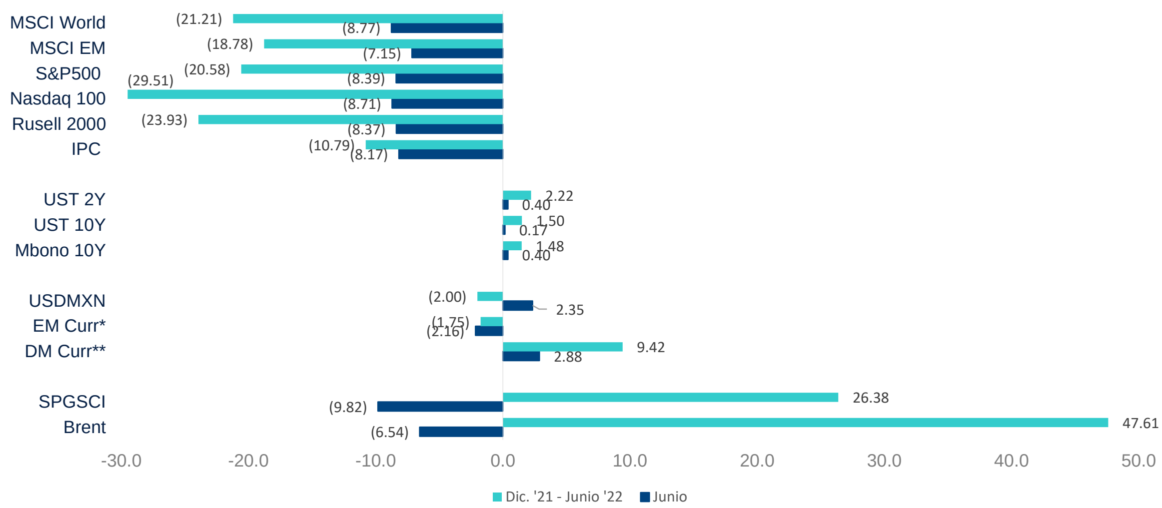
It is important to note that fears of recession and the slowdown in China may already be priced in, as prices of industrial metals fell 13.8% in June, bringing their cumulative decline during the quarter to 12.3%.

Looking ahead, the confluence of factors of varying nature makes it very complex to try to predict any trend in the financial markets. Most likely, market participants will show increasing sensitivity to US economic activity data, leaving the inflationary part somewhat aside.

However, the answer as to the magnitude of the possible recession depends largely on the degree of persistence of inflation, and this will be related to uncertain issues such as the war in Ukraine, the resolution of bottlenecks in the value chains, and the peculiar dynamics of the US labor market.

Conditions do not yet seem propitious for market participants' expectations to be anchored on a particular narrative, even though efforts in this regard are heard on a daily basis.

Chart 1. **PERFORMANCE OF MAJOR FINANCIAL ASSET PRICES IN 1H22** (% CHANGE IN DOMESTIC CURRENCY)



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

3. Regulation

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

Resolution **amending the general provisions applicable to credit institutions.** Capital requirements for securitizations are adjusted with the introduction of an external ratings based approach (replacing the standardized approach), whereby, depending on the corresponding degree of risk, different weightings are established for the short and long term in local and global scales, according to their effective term or maturity.

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