Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

The greater dynamism in business lending in June led to a better performance of credit to the non-financial private sector (NFPS)

During June 2022, the nominal balance of the outstanding loan portfolio granted by commercial banks to the NFPS grew by 11.1% per annum. Filtering out the effect of high inflation, the increase was 2.9% in real terms, higher than the 2.2% observed in May. For the second consecutive month, real annual growth was recorded in all portfolios that make up this type of financing. In particular, the corporate portfolio showed a real annual variation of 1.9%, the second month of positive rates, an acceleration compared to 1.1% in May.

By aggregates that make up credit to the NFPS, the annual nominal variations were: consumption, 13.4% (5.0% real); housing, 11.7% (3.4% real); and business, 10.0% (1.9% real). In June 2022, the contributions to the 10.2 pp growth of bank credit to the NFPS were (in descending order): business, 5.6 pp; consumption, 2.9 pp; and housing, 2.6 pp.

During the sixth month of the year, the depreciation of the peso in year-on-year terms magnified the increase in the outstanding nominal balances of the corporate portfolio in foreign currency. Expressed in pesos, this portfolio presented a nominal variation of 14.9% (9.1% in the immediately preceding month (IPM) and -28.1% in June 2021), which in dollars is equivalent to 13.6% (10.4% in the IPM and -16.6% in June 2021). Nominal outstanding balances in local currency increased by 8.7% in June (after having recorded 8.8% increases in the IPM and a contraction of -6.7% in June 2021).

However, overdue balances in foreign currency have increased substantially, presenting an annual nominal variation of 108.7% (106.3% in USD), accumulating a semester of increases of more than 100%, although, since February, each month has exhibited a lesser magnitude. In particular, the portfolio of individuals with business activity (IBA) saw a decline in its overdue balances (which are now close to zero), pointing to the fact that companies are the subjects of these defaults.

Although the dynamism of commercial bank financing to the NFPS observed in recent months allows us to speak of a recovery, it is worth noting its partial nature. At the end of the first half of 2022 (1H22), the real balances of the consumer and corporate loan portfolios were 8.9% and 7.2% lower than those recorded in February 2020, respectively.

The improvement in the disposable income of households and companies is a prerequisite to consolidate a greater demand for credit in the medium and long term, without negatively affecting the quality of the portfolio; that is, ensuring that the current dynamism of balances does not lead to an increase in defaults due to a lack of ability to pay.

Time deposits resume growth after 22 months of contraction

In June 2022, the balance of traditional bank deposits (demand + time) recorded a real annual growth rate of 2.1% (10.2% nominal), maintaining the growth rate observed in the last two months, to average real growth of 1.8% in 2Q22, an improvement over the -0.5% average drop recorded in the previous quarter. Demand deposits continue to boost traditional deposits, and in June contributed 1.9 percentage points (pp) to their growth, while time deposits for the first time in 22 months contributed 0.1 pp to their dynamism.

Demand deposits recorded a real annual growth rate of 2.9% (11.1% nominal), lower than the dynamism observed between January and May of this year (which averaged 3.5% real). The holders that contributed most to the annual growth recorded in June were companies and individuals, whose demand deposits recorded a real annual variation of 5.9% and 3.4%, respectively.

In the case of companies, the annual growth rate improved with respect to May (when a rate of 5.1% was recorded), partly reflecting the good performance of company revenues in some sectors, such as those engaged in trade. In May (latest available information) they recorded a higher annual revenue growth than that observed in the previous month: 8.0% in the case of wholesale trade (vs. 5.4% in May) and 5.2% for retail trade (vs. 4.6% in the previous month).

In the case of individuals, the 3.4% growth recorded in June is lower than that observed the previous month (5.1%) and the average for the first five months of the year (4.1%). The reactivation of household spending together with a slight moderation in the growth rate of formal employment could explain this decrease in the dynamism of demand deposits.

For the first time since July 2020, time deposits recorded a positive annual variation of 0.4% in real terms (8.4% nominal). Among holders of this type of savings, individuals recorded a real annual growth rate of 2.9% in June, improving their performance with respect to the previous month (1.0% in real terms). In addition, time deposits from other financial intermediaries also managed to climb into positive territory, recording a growth rate of 1.6%, the first observed after 25 consecutive months of declines (since May 2020).

This recovery was enough to offset the annual rate decline that continues to be seen in the balances of companies and the non-financial public sector, which are still recording annual rate contractions. Thus, the increase in interest rates is beginning to increase the relative attractiveness of this type of savings instrument, improving its performance.

Increased participation of pay-in-full credit card customers

Banco de México (Banxico) published the report on ["Basic Indicators (RIB) for Credit Cards"] (CCs) with data as of June 2021. The purpose of the document is to follow up on the terms and conditions of this type of credit. This report includes an analysis of CCs "*comparable portfolio*"[1], which is classified into two groups of customers: i) pay-in-full customers (those who pay off their entire balance at the cutoff); ii) and non-pay-in full customers (who pay off a portion of their outstanding balance).

Overall, the CCs balance accounted for 37.2% of the total consumer credit balance, which represented a slight decrease compared to the same month in 2020 (when the said share was 37.7%). In the period from June 2020 to June 2021, the total balance of the CCs portfolio decreased at a rate of 8.6% real compared to June 2020.

The CC delinquency rate (CCDR) improved compared to June 2020, going from 5.4% to 4.5%, partly due to portfolio write-offs. When considering the effect of write-offs and write-downs, the DRA (Adjusted DR) as of June 2021 was 17.1%, the same as the previous year.

In June 2021, the comparable portfolio consisted of 18.6 million cards with a balance of Ps. 319.3 million. Of this total, 61.3% of the cards and 37.9% of the balance corresponded to pay-in-full customers. It should be noted that the share of this type of customer increased with respect to the previous year, when it accounted for 54.6% of all cards and 29.5% of the total balance. For the total comparable portfolio, the average credit limit increased from $58,448 to $60,033 between June 2020 and June 2021, while the Weighted Average Effective Interest Rate (WAER) stood at 20.5%, lower than that recorded in the same month of the previous year (24.3%).

The balance of personal loans reduced its decline and there was a relative improvement in portfolio quality

In July 2022, the Bank of Mexico (Banxico) updated its report ["Basic Indicators for Personal Credits"], with information as of the end of August 2021. The balance of this type of loan accounted for 17.2% of the total consumer loan portfolio, a reduction of 1.4 percentage points with respect to its share a year earlier (when it accounted for 18.1% of the total). In the August 2020 - August 2021 period, the personal loan portfolio balance recorded a real annual decline of 11.7%, a relative improvement over the 19.4% decline recorded in August 2020.

In August 2021, the DR for personal loans was 5.4%, lower than the 5.8% reported in the same month of the previous year. This relative improvement in portfolio quality was also reflected in the DRA, which went from 17.3% to 17% in the reporting period.

Between September 2020 and August 2021, 6.8 million personal loans were placed, accounting for 82.3% of the total number of outstanding loans. The amount associated with loans granted in the last year accounted for 71.2% of the

1: This set of analyses excludes CCs that do not have market conditions (cards granted to employees of the issuer are excluded), have payment problems (cards with arrears or delinquencies) or have received different treatment that alters their original granting conditions (restructured cards).

total balance. Although most of the loans granted were for amounts less than $5,000 pesos (53%), their share of the total balance is equivalent to only 8% of the amount placed.

On the other hand, loans of more than $30,000 account for a smaller number of the total (6%) but have a higher share of the total balance granted (57%). Among the most significant changes in the reference period is the average amount per loan granted, which rose from $18,210 to $18,350. Similarly, the average term increased from 25 to 26 months during the same period and the weighted average rate increased from 38.3% to 38.9%.

2. Financial Markets

Bear market rally for financial assets in July?

After a first half of the year with significant losses, financial asset prices recorded a significant recovery in July. This recovery, lacking fundamentals in the economic context, indicates how the changing narrative has become embedded in the expectations of market participants.

Weak activity data from the Chinese economy and the narrative that the tightening stance of the Federal Reserve (Fed) will slow the U.S. economy towards the second half of 2022 and translate into a recession of uncertain magnitude by 2023, influenced a decline in commodity prices during the seventh month of the year.

The benchmark for this type of assets (S&P GSCI) recorded a 2.3% drop in July, thus making two consecutive months of declines. Within this indicator, declines were generalized, although of greater magnitude in the case of the energy sector (see graph 1). In fact, the price of a barrel of Brent crude oil fell 4.2%, while the price of the Mexican blend fell 6.2%.

Despite a further increase in U.S. inflation in June to 9.1% (its highest level in 40 years), the above-described performance of commodities and expectations of lower economic activity reaffirmed the impression that we are now witnessing the "peak" of inflation in the U.S. These elements, together with the Fed's restrictive cycle, were reflected in a drop in inflation forecasts for July, both market and survey-based.

Thus, during the first three weeks of the month, the prices of medium and long-term fixed income assets and equities recorded gains, the latter additionally supported by U.S. corporate reports that were mostly in line with expectations.

It was against this backdrop that the Fed's Federal Open Market Committee (FOMC) meeting took place during the last week of the month, exacerbating gains in both fixed income and equity markets. Although the communique was regarded as far from comforting, the Fed Chairman's statements that the pace of interest rate hikes could slow in the coming months depending on the data and, given that the federal funds rate had reached a neutral level, were interpreted by market participants as a signal to increase risk positions.

Little consideration was given to the reiterated statement that the Fed is focused on reducing inflation and that to do so it will need to generate more slack in the economy through additional rate hikes, or to the comments that it is preferable to err on the side of excess rather than moderation when raising rates, given that price stability is the basis for a well-functioning economy.

As a result, interest rates on Treasury bonds fell across the board during July as expectations for higher rates and economic growth declined. The yield to maturity of the two-year bond fell 7 base points (bps) in the month under review, of which 17 bps of reduction took place in the last three days of the month. In the long part of the curve, the fall was 36 bps in July, so that the yield to maturity closed at 2.65%. As a result of these movements, the slope (2Y-10Y) closed July in negative territory.

This reduction, together with a lower level of risk for Mexico, influenced a 47 bp drop in the 10-year Mbond during July, with the yield to maturity closing at 8.58%. This is despite inflation in the first half of July exceeding expectations and even though Banxico is expected to increase the reference rate above 9.0%.

In the stock markets, there were gains practically across the board (see graph 1). Leading the way were the North American indices, in particular the Nasdaq, which rose (+12.45) in July, enabling it to cut its first-half losses by a third. In Europe, the STOXX 600 had more moderate gains (+7.64%), while in Mexico, the IPC of the BMV improved by 1.3%. It is important to note that the Mexican market differed positively from the rest of the emerging markets, whose benchmark recorded a 0.7% drop.

In the foreign exchange market, lower rate hike forecasts translated into lower dollar strength towards the end of the month, which was not enough to erase its gains during July. The U.S. currency ended with gains of 2.4% against emerging currencies and 1.2% against those of developed countries.

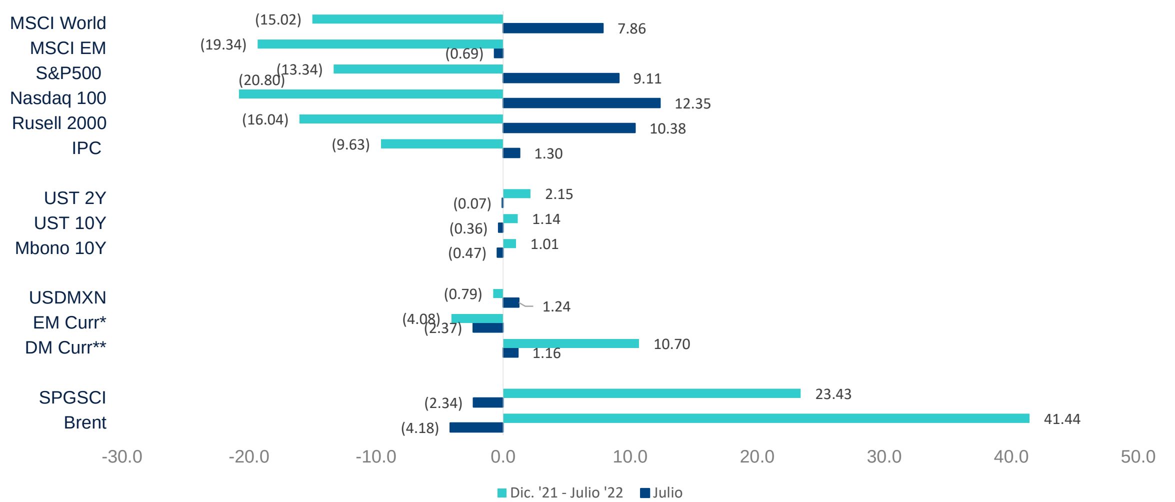
For the Mexican peso, the fall of the dollar and the greater appetite for risk meant an appreciation of 0.5% after the Fed meeting, which was not enough to avoid a depreciation of the exchange rate of 1.25% in July. As a result, the exchange rate closed the seventh month of the year at 20.4 pesos per dollar.

The above movements in July suggest that market prices are absorbing the expectation that inflation will not only begin to decline starting in August, but that it will do so relatively quickly, allowing the Fed to slow its pace of rate hikes.

Additionally, prices seem to reflect that the tight monetary policy cycle will indeed generate a recession, but of short duration and depth, which will not significantly affect the corporate sector. That is, the recession will indeed lead the Fed to cut rates at some point in 2023, but it will not have a significant effect on corporate earnings, a favorable combination for risky assets.

In short, in the search to balance out expectations, market participants are tending to stick to a narrative that has no clear relationship with the economic context and could still prove to be very unstable.

Graph 1. **PERFORMANCE OF MAIN FINANCIAL ASSETS PRICES: JULY AND ACCUMULATED 2022**
(% VARIATION IN LOCAL CURRENCY)



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

3. Regulation

Projects under consultation

06.07 **Draft provisions on the "Rules applicable to the Unique Transaction Identifier (UTI) and Unique Product Identifier (UPI) in derivative transactions" and amendments to the "Rules for the conduct of derivative transactions"**

Establishes unique identifiers, as well as their terms and conditions, in order to facilitate the aggregation of data and identify risk exposures, both in recognized markets and in OTC transactions.

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

Its purpose is to adjust the existing requirements of the Contingency Plans designed to restore the financial situation of institutions in the event of adverse scenarios that could affect their solvency or liquidity, including the following:

- Greater detail on organizational changes (mergers, spin-offs, sale of businesses, etc.); business or equity links; characteristics of its infrastructure, geographic distribution, branches and ATMs; its business group or parent company, among others.
- Definition of roles and responsibilities related to the Plan, monitoring of indicators (thresholds) and their activation, execution of recovery measures, follow-up, evaluation and continuous improvement.
- Internal and external communication strategy, measures taken in case of negative market reactions, communication managers (decision, content, scope, deadlines, channels, etc.).
- Minimum quantitative requirements to be considered (capital, liquidity, profitability, asset quality, external rating, share price; action thresholds and detail of measures to be taken).
- Possibility to use the capital and liquidity stress tests for the purposes of the required annual test, provided they are placed in categories III, IV or V for capital and LCR, as well as scenarios II, III or IV for NSFR.

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