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Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

Growth of non-financial private sector credit stabilizes in August

In August 2022, the outstanding loan portfolio balance granted by commercial banks to the non-financial private sector (NFPS) grew at an annual rate of 3.2% in real terms (12.4% nominal), equal to the real growth recorded the previous month. At a real monthly rate, growth remained above the average observed in the first seven months of the year (1.5% vs. 1.2%). The three portfolios that make up this credit aggregate have recorded real growth at annual rate, although the corporate and housing portfolios saw a reduction in performance. This slowdown was offset by greater performance in consumer credit. Of the 3.2% growth recorded in August, consumer credit contributed 1.3 pp, business credit 1.2 pp and mortgage loans 0.7 pp.

Outstanding credit to companies (55.4% of the total portfolio to the NFPS) grew at a real annual rate of 2.1% in August (11.0% nominal), slightly below the performance observed the previous month (2.2% real). As in July, there was a notable increase in outstanding balances denominated in foreign currency (22.3% of total business loans), which grew by 11.1% in real terms in August, the second consecutive month with double-digit growth rates. In contrast, business loan balances in domestic currency continued to show a slight decline, registering a 0.3% drop, thereby delaying a more solid recovery.

This relative stagnation in business loans could be associated with the mixed performance of income sources in some sectors: in July (latest available information), the general index of income from the supply of goods and services recorded 1.4% growth for wholesale trade in July, lower than the 4.5% recorded in June, and for companies in the services sector, this index dropped from an annual growth of 3.8% to 2.7% in the same comparison period. In contrast, retail trade accelerated its performance slightly (from 4.0% to 5.0%). In addition to weak income recovery, the increase in the cost of financing may be limiting further growth in the corporate loan portfolio.

Consumer credit (21.8% of the total) reached a real annual growth rate of 6.2% at the end of August 2022 (15.4% nominal), surpassing the performance observed in July (5.6% real annual growth). The only portfolio that has not yet managed to recover its momentum is that of automotive loans, where balances fell 3.7% in real terms in August, an improvement compared to the 4.3% contraction of the previous month. This relative improvement reflects the slight growth in automobile sales of 2.4% in August, the first positive figure after 12 consecutive months of declines.

The need to finance households' current expenditure, together with the dynamic performance still observed in formal employment and real wages (which grew by 4.0% and 2.3%, respectively, in August), continues to drive the recovery of the rest of the consumer credit segments. In the case of outstanding credit card balances, performance improved in August, registering real annual growth of 7.1% (up 6.3% from the previous month), payroll loans grew 6.2% in real terms (the same as the previous month) and personal loans increased 7.6% in real terms (vs. 6.3% in July).

Outstanding housing loans (22.7% of the total portfolio) experienced a greater slowdown. In August, real annual growth of outstanding balances stood at 2.9%, lower than the figure observed in the first seven months of the year (3.3% on average). This downward trend could continue, as the portfolio's dynamism reflects the lagging performance of formal employment, which, together with the increase in long-term interest rate hikes, could lead to lower demand for mortgage loans.

In summary, the performance of the different bank loan portfolios continues to show a non-homogeneous recovery, with a slowdown in mortgage loans, a stagnation in the recovery of business loans, and a greater dynamism in consumer credit. This suggests that the demand for credit is shifting toward financing the short-term needs of households, which would be consistent with a scenario of high inflation rates that may be eroding household purchasing power.

Although delinquency rates currently remain at manageable levels (2.9% for consumer, 2.8% for housing and 2.2% for corporate), it will be essential to maintain prudent lending practices in order to preserve healthy loan portfolios going forward.

Traditional bank deposits weakened in August due to stagnation of sight deposits

In August 2022, the balance of traditional bank deposits (sight + term deposits) recorded a real annual growth of 1.1% (9.9% nominal), slowing its momentum for the second consecutive month. Although this result exceeds the average of the first seven months of the year (a period which saw an average real growth rate of 0.8%), it is below the results of June (2.1%) and July (1.9%). Contrary to what has been observed in the course of 2022, sight deposits ceased to contribute to this dynamism, so that the growth of traditional deposits is now only supported by the performance of term savings.

Sight deposits registered 0% annual growth in real terms (8.6% nominal), their lowest since July 2019. While this behavior could be because of the need to increase household current expenditure during the back-to-school season, as well as the higher opportunity cost of holding liquid resources, the magnitude of the slowdown points to the presence of an additional factor.

In fact, in monthly terms, the drop in individuals' sight deposits was -3.4%, placing it in the worst 10% of monthly growth for the month of August in the last 16 years. The additional factor that could be responsible for this drop is a spending of the resources saved during the pandemic, now that the COVID-19 restrictions have practically disappeared.

While sight deposits of companies and the non-financial private sector still registered positive annual change (0.4% and 0.5%, respectively), sight deposits of individuals showed contraction for the first time in 13 years (0.3%), while deposits of other financial intermediaries accumulated 19 consecutive months of decreases (0.6% in August).

Term deposits registered annual growth in real terms of 1.1%, an accumulated three months of recovery. Among the sectors holding this type of savings, deposits held by individuals continued to lead the recovery, with a real annual growth rate of 1.0% in August, improving their performance with respect to the previous month (0.8% in real terms).

Deposits from companies and other non-financial intermediaries also began to report a recovery, but significantly weaker (0.1% in real terms in both cases). Although the increase in interest rates has made term savings more attractive, a greater boost to the amount of this type of savings could be strengthened by a stable flow of agents' incomes.

Due to term savings' lagged response to interest rate hikes, the accelerated depletion of liquid resources (sight deposits) could result in a reduction in traditional bank deposits by the end of the year.

Risks to financial stability related to the adjustment of monetary policy stances

The Financial Stability Board (FSB) updated its balance of risks. Among the challenges faced by the Mexican financial system in the current situation, the FSB highlights that, with respect to its last review, the outlook for global economic activity has deteriorated, while inflation continued to rise. In this environment, several countries have accelerated the tightening of monetary policy, leading to a tightening of global financial conditions, which has been coupled with spikes in market volatility.

In Mexico, in particular, in the face of the generalized increase in interest rates, financial markets showed mixed behavior, with episodes of volatility (reflecting greater uncertainty and risk aversion), and the exchange market exhibited stable behavior. The FSB comments that, although economic activity continues to recover, its growth rate has slowed, and there is still a risk of a further weakening of domestic demand in the future.

Thus, the main risks identified in this update relate to a more accelerated or disorderly tightening of financial conditions, which could translate into greater volatility and reduced growth in economic activity.

At the end of the third quarter of the year, the Mexican banking system continues to show a solid position regarding capital and liquidity levels above the regulatory minimums. However, the FSB highlights that the potential materialization of any of the identified risks could result in a deterioration in the quality of the banking system's loan portfolio.

Outstanding credit falls in the Center of the country in 2Q22 due to lower financing for agricultural and industrial activities

According to Banco de México's Regional Economies Report[1] and based on the Credit Market Conjunctural Evaluation Survey (EECMC) corresponding to 2Q22, the performing portfolio of non-financial private companies in commercial banking presented a real annual growth[2] of 1.9% in 2Q22, the first quarter with a positive year-on-year change since 2Q20.

Bank credit in the north region, which accounts for 22% of credit, contributed 1.4 of these 1.9 pp, while 0.7 pp are attributable to the north central region, 0.3 pp to the south region, and 0.5 to the central region.

During 2Q22, regarding the performing portfolio by type of activity, the primary sector showed contraction only in the central region of the country, with a real annual change of -7.5%. In contrast, the performing portfolio for primary activities in the south grew 15.2%, while the north and north central regions experienced growth of 10.8% and 7.7%, respectively. For industry, the largest drop remained in the south region, with a real annual change of -6.0%, followed by the central region (-4.4%). Financing for industry in the north region increased 5.9%, while in the north-central region it increased 1.3%. Regarding services, all regions recorded real annual growth rates. The south experienced the highest increase (7.9%), followed by the north (6.6%), north central (5.4%) and central (2.2%) regions.

Although total business financing continues to accelerate, the regionalization of credit trends shows a pattern of stagnation in industry with respect to services, implying a tertiarization in the loanable funds market parallel to that observed in the real sector of the economy.

Weak external demand in the face of less dynamic foreign trade is having a major impact on the manufacturing sector. The lingering effects of the economic contraction and the risk of a stagnation in activity in the medium term, together with the increase in the price of inputs generated by the persistence of inflation, imply a lower value of expected income flows in sectors such as construction and manufacturing. This impacts the demand of businesses borrowing from banks for these activities, which has led to a decrease in lending activity in the medium term in regions such as the center and south of the country.

Although the north and north central regions have also been affected by these dynamics, phenomena such as nearshoring have improved the prospects for industrial development in these regions, resulting in a more favorable trend in outstanding credit balances.

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

2. Financial Markets

Persistently high inflation dampens expectations of a near-term change in the Fed's stance

Toward the beginning of September, the idea of a soft landing for the US economy started to spread again among market participants, which was reflected in a brief risk-on mood. However, similarly to previous events, first the above-expected US inflation data in August, and later the Fed's announcement, reinforced expectations of a more restrictive and sustained monetary cycle, which reversed the above-mentioned price hikes.

In addition to the macroeconomic indicators in the US, the proposed tax cut in the United Kingdom added volatility to the market and triggered an intervention by the Bank of England as the pound and the price of long-term sovereign bonds fell.

Against this background of expectations of higher interest rate levels over a longer period of time, the yield to maturity (YTM) of the two-year Treasury bond rose 79 basis points (bp) in September, bringing it to 4.27%, an increase of 355 bp so far this year. Meanwhile, the 10-year node increased by 64 bps, to close September at 3.83%, bringing the slope of the curve (2Y10Y) to -45 bps. With this new rate hike, at the end of September, the US government bond benchmark had lost 13.0% year-to-date (see graph 1).

In Mexico, the M10 increased 61 bp in September, in line with the rise in its US counterpart and a high inflation scenario that remained above expectations in the first half of September (8.70%). Thus, the YTM of the M10 closed at 9.67%, slightly below its high for the month of 9.85%. It should be noted that in the short part of the curve, the six-month bill is already above 10.0%.

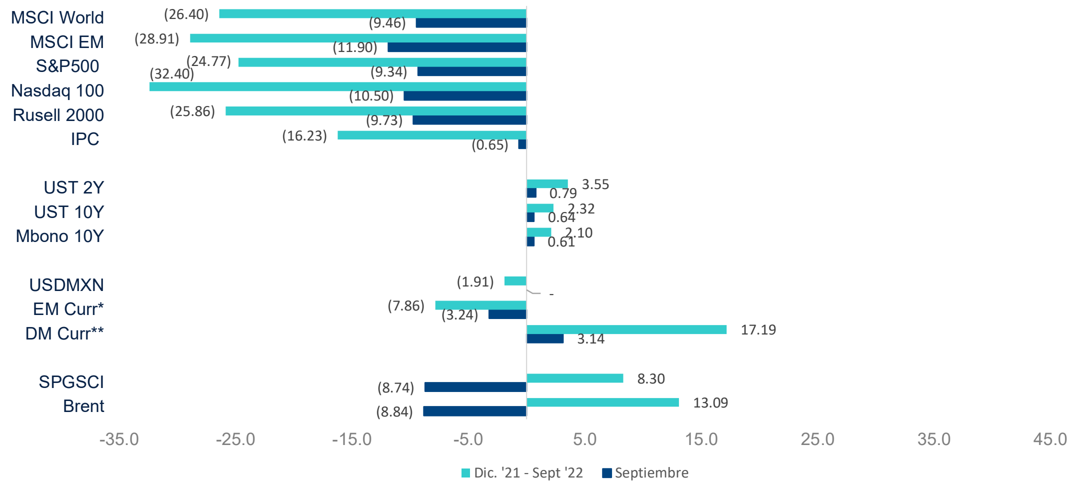
The increase in interest rates was reflected in overall declines in the stock markets. Once again, the Nasdaq 100 registered the largest decline (10.50%) among the US indexes due to technology stocks' high sensitivity to rate hikes, given their concentration of long-term flows. On this occasion, the emerging countries' equity benchmark (MSCI EM) led the declines among the main global indexes, although the IPC of the Mexican Stock Exchange notably experienced a fall of less than 1.0% (see graph 1).

In the foreign exchange market, in addition to the significant depreciation of the pound, the Mexican peso was once again stable in an environment of a globally strengthening dollar. The exchange rate closed September practically unchanged at 20.14 pesos per dollar. In contrast, the emerging market currency benchmark fell 3.24% against the dollar in September, while the developed-currency benchmark dropped 3.14%.

Ultimately, the global benchmark commodity index (S&P GSCI) recorded its fourth consecutive month of decline, supported by an overall reduction in its components (see graph 1). This behavior has been part of the rationale of those who point to an early reduction in inflation. However, a high persistence of price increases is observed at a global level, which suggests that the pricing dynamics itself is already being affected.

Bottomline, at the end of September, risk asset prices seem to have buried the possibility of a change in the Fed's stance (Powell Pivot). As long as there is no evidence that inflation is on a track toward the 2.0% target, the Fed will maintain its tightening stance even if this implies a reduction in economic activity. Risks to financial asset prices remain skewed downward.

Figure 1. **TREND IN THE PRICES OF THE MAIN FINANCIAL ASSETS DURING SEPTEMBER AND YEAR-TO-DATE** (CHANGE AS A % IN LOCAL CURRENCY)



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

3. Regulation

Draft amendments under consultation

July 6 **Draft provisions on "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"**

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

September 9 **Banxico — Draft amendments to the rules to which financial institutions must abide in their repurchase transactions**

Incorporates trust certificates issued by the National Infrastructure Fund (FONADIN) as eligible securities for repurchase agreements.

September 9 **Banxico — Draft amendments to the rules for derivative transactions, contained in Circular 4/2012, regarding credit derivatives**

Broadens the type of counterparties with which banks may enter into Credit Derivative Transactions; allows banks to enter into Credit Default Swaps and Total Return Swaps without leverage, with brokerage firms, investment funds, specialized retirement fund companies, insurance institutions and other institutional investors whose regimes allow them to do so.

September 21 **Conamer — Resolution modifying the Dispositions applicable to credit institutions**

Updates Moody's credit rating scale for use in the calculation of credit risk capital requirements under the standardized approach; also updates the sources of information and indicators contained in Exhibit 1-T Bis to make them consistent with the accounting criteria of IFRS 9.

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

September 2 General provisions applicable to CNBV credit institutions. The requirements of the Contingency Plans are adjusted and detailed, highlighting the following: organizational changes; business or equity links; characteristics of the Plan's infrastructure and geographic distribution; roles and responsibilities related to the Plan; monitoring of indicators (thresholds) and their activation; execution of recovery, follow-up, evaluation and continuous improvement actions; internal and external communication strategy; and minimum quantitative requirements to be considered.

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