Creating Opportunities

Banking

Monthly Report on Banking and the Financial System

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Banking and the Financial System

Non-financial private sector (NFPS) credit grew 12.8% in nominal terms in February, with greater dynamism in real terms in all portfolios

During February 2023, the nominal balance of the performing loan portfolio granted by commercial banking to the NFPS grew 12.8% annually, a figure similar to that registered since November 2022. However, in real terms (after stripping out the inflationary effect), this increase is equivalent to 4.8%, higher than that observed in January and the highest real growth since May 2020. Real growth also accelerated in all the portfolios that make up this type of financing, even in the current situation of higher interest rates, which could be partially explained by greater consumer confidence, as well as by the better performance of tertiary activities, in the case of business loans.

By portfolios that make up the loans to the country's NFPS, the annual nominal growth rates were: consumption, 18.0% (9.6% real); housing, 11.8% (3.9% real); and business, 11.2% (3.3% real). In February 2023, the contributions to the 12.8 percentage point (pp) growth of bank credit to the NFPS were (in descending order): business, 6.2 pp; consumption, 3.9 pp; and housing, 2.7 pp.

During the second month of the year, the year-on-year appreciation of the peso mitigated the increase in the outstanding nominal balances of the business portfolio in foreign currency. Expressed in pesos, this portfolio presented a nominal variation of 11.1% (12.2% in the immediately preceding month (IPM) and 2.3% in February 2022), which in dollar terms is equivalent to 23.7% (23.2% in the IPM and 4.9% in February 2022). Nominal outstanding balances in domestic currency increased 11.3% in February (after registering increases of 11.2% in the IPM and 1.5% in February 2022).

During the second month of 2023, outstanding business loans registered heterogeneous dynamics, with sectors such as the generation, transmission, distribution and commercialization of electricity, water and natural gas growing 172.8% in real terms, and construction returning to positive territory in real annual terms, with a growth of 0.2%. Meanwhile, both the agricultural and manufacturing sectors registered a slowdown in real terms, with growth rates of 1.1% and 2.1% (2.3% and 4.7% in the IPM), respectively.

In terms of tertiary activities, the dynamism of financing to the trade sector, which grew 5.3% in real annual terms in February, offset the slowdowns in sectors such as real estate services, professional services and the contraction of real balances in the hotel and restaurant sector. This, together with a significantly lower contraction in transportation and mass media services than that of the IPM, implied a real annual growth of 5.3% in tertiary activities, significantly higher than the 3.9% registered in the IPM.

As for the observed recovery of balances with respect to their pre-pandemic levels, real balances of business loans are still 7.8% lower than those recorded in February 2020. By type of activity, the primary sector registered a reduction of 3.7% with respect to the reference period, the same observed in most secondary activities, with real balances in mining falling 42.3%, while manufacturing and construction registered levels 10.8% and 9.2% lower than those of February 2020.

Although the 68.5% real growth of real balances in the electricity, water and gas sector is noteworthy, its share in the business portfolio remains small, with an increase of only 0.25% to 0.46% in the last three years. Additionally, the real balances of financing to tertiary activities registered a level 7.3% lower, with real contractions of 21.3% in the mass media sector, 16.2% in the trade sector, 15.0% in professional services, and 8.1% in real estate services. Real balances in hotels and restaurants are 4.6% below the level recorded in February 2020.

Regarding the behavior of performing consumer credit, its growth in February was mainly supported by the credit card segment, whose outstanding balances registered a nominal annual variation of 22.7% (14.0% real), reflecting a persistence in the acceleration that the segment has exhibited in recent months. Outstanding nominal balances for the acquisition of consumer durables grew 12.8% YoY (4.8% real), with automotive loans contributing 10.0 pp to this increase and the acquisition of movable property, 2.8 pp. As for payroll and personal loans, nominal outstanding balances increased 17.5% and 13.9% (9.2% and 5.8% in real terms), respectively. In the case of personal loans, this variation represents a slowdown with respect to the IPM, while the dynamism of payroll loans increased during February, in line with the acceleration of real wages.

Despite the dynamism observed in consumer financing over the last year, it is still 3.1% below its February 2020 level. By segment, this is the result of a 19.0% decrease in personal loans, 10.1% in automotive financing and 3.2% in credit card balances. In contrast, the payroll and movable property acquisition segments already present outstanding balances 4.5% and 88.9% higher than those of the pre-pandemic period, respectively.

Although the dynamism of the different credit portfolios to the NFPS has evidenced a recovery of outstanding balances three years after the beginning of the covid-19 health crisis, the recovery of real balances has not been across the board. In the case of the housing portfolio, the only one that has not shown contractions since February 2020, the outstanding portfolio is 11.9% above its February 2020 level. This growth has brought along a recomposition of balances toward the medium-residential housing segment, which recorded an increase of 15.3% in real terms, compared to its pre-pandemic level. This has been to the detriment of low-income housing loans, whose balances in February 2023 are 35.6% lower than those recorded in February 2020.

The delinquency rate of credit to the NFPS has marginally decreased to 2.38% in February 2023 (vs. 2.40% in the IPM and 2.90% in February 2022). However, there are signs of deterioration in some segments. In the case of consumer credit, non-performing loans in February 2023 were 2.96%, slightly lower than the 2.97% recorded in January, but showing increases in the credit card and personal loans segments. Regarding the housing portfolio, the delinquency rate was 2.53% (2.56% in the IPM), with a deterioration in the low-income housing segment and an improvement in the case of medium-residential housing. As for the non-performing loans (NPL) ratio for business financing, the indicator registered 2.08% in February 2023 (2.10% in the IPM).

Slowdown in term deposits and contraction of sight deposits resulted in a real drop of -1.4% in traditional bank deposits

In February 2023, the balance of traditional bank deposits (sight + term) registered an annual contraction of -1.4% when discounting the effect of inflation (equivalent to a nominal growth of 6.1%), accentuating the slowdown that had been registered in January, when the reduction in real terms in the balance was 0.1%.

As in the previous month, the fall observed in February partly reflects the accounting effect associated with the appreciation of the exchange rate, downwardly affecting the valuation in pesos of balances denominated in foreign currency. Term deposits continue to be the most dynamic component of deposits, contributing 1.7 pp to the real annual variation, while sight deposits reduced this dynamism by -3.1 pp.

In the second month of the year, sight deposits (65.6% of traditional deposits) recorded an annual fall of 4.6% in real terms (growth of 2.7% nominal), increasing the decline observed in January (-2.8%) and marking the largest contraction recorded since June 2019.

Both corporate and individual deposits contributed to the decline in February. In the case of companies, the real annual change was -5.0%, while the sight deposits of individuals decreased -7.3% in real annual terms.

The dynamism in the consumption of services during February may partially explain the contraction observed in the sight deposit balances of individuals, while in the case of companies, lower sales during the month (due to decreased dynamism in the consumption of goods) would contribute to the contraction observed. In addition, an environment of higher interest rates favors the term deposits over sight deposits.

Three years after the start of the pandemic, bank deposits have experimented a recomposition of balances between deposit rates, as well as between deposit holders.

Real sight deposits balances (stripping out the inflationary effect, but not the exchange rate effect), are 13.9% above the level recorded in February 2020. By holder, the non-financial public sector and the private sector have balances that are 28.4% and 16.1% higher, respectively.

In the case of the private sector (representing 83.9% of sight deposits), this is partially the result of the accumulation of liquidity during the pandemic. The deposits of other financial intermediaries, on the other hand, experienced a 22.9% contraction with respect to their pre-pandemic balance, with falls of 347.0% and 30.1% in the balances of development banks and private sector non-bank financial intermediaries. On the contrary, public sector non-bank financial intermediaries increased their real balances by 11.0%.

Meanwhile, there was a slowdown in term deposits in the second month of the year, reaching a real annual rate of 5.1% (13.1% nominal), lower than the rate recorded in the MIP (5.4% real). Term deposit balances of companies registered a real growth of 1.3%, lower than the 3.0% recorded in January. In the case of individuals, double-digit dynamism was maintained for the fourth consecutive month, with a real growth rate of 13.5% in February, similar to that observed in January.

As for term deposits, the real balance is 10.6% below its February 2020 level. By holder, the strongest fall is that of the non-financial public sector, with a real variation of -68.6% with respect to the reference period, followed by other financial intermediaries, which have registered a contraction in this type of savings of 33.9%, as a result of falls of 35.9% and 33.7% in the balances of private and public non-bank financial intermediaries, respectively, as well as a contraction of 25.8% in the term deposits of development banks.

Regarding the private sector, the real balances of companies are 9.8% above their pre-pandemic level, being the only holder whose term balances are higher than those they had in February 2020, while those of individuals are 7.6% lower three years after the start of the covid-19 pandemic.

The end of the rate hike cycle and subsequent interest rate cuts would leave behind much of the motivation for the recomposition of deposits into term instruments that higher yields have implied.

Moving forward, in order to see growth in sight deposits and traditional fund-raising as a whole, sustained growth in labor market variables - employment and real wages - would need to be maintained, along with a more moderate consumption path in the medium term, which would allow the accumulation of part of the additional income in the form of bank deposits.

Outstanding loans registered strong growth in the Center-North and South of the country in 4Q22, due to increased financing for industrial activities

According to the Banco de México Regional Economic Report October-December 2022[1], based on the Credit Market Survey (EECMC for its acronym in Spanish) corresponding to the fourth quarter of 2022 (4Q22), the outstanding portfolio of non-financial private companies in commercial banking presented a real annual growth[2] of 3.0% in the last quarter of the year, a similar dynamism to that registered in 3Q22, although with changes in the regions and activities generating such growth.

Bank loans in the Central-North region, which accounts for 17% of credit, contributed with 1.74 of these 3.0 percentage points (pp), while 1.41 pp are attributable to the North region of the country, 0.83 pp to the South region, and 0.82 to the Central region.

By type of activity during 4Q22, the performing portfolio of the primary sector only grew in the North Central region of the country, with a real annual variation of 7.6%. In contrast, the outstanding portfolio for primary activities in the North fell 2.1%, while in the South and Central regions, the contractions were 0.7% and 0.3%, respectively.

In the case of industry, the only decline during 4Q22 was recorded in the Central region, with a real annual change of -5.3%. Financing to industry in the South region increased 22.6%, while in the North Central and North Central regions it increased 16.3% and 3.1%, respectively. With respect to services, all regions recorded real annual growth rates for

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.

the second consecutive quarter. The North experienced the largest increase (11.4%), followed by the South (8.6%), North Central (7.0%) and Central (1.3%) regions.

Although total corporate financing presented a similar rate to the previous quarter, the pattern of credit dynamics reflects a lower dynamism in the Central region, explained by the contraction of outstanding balances in industry and, for the most part, in services.

The reactivation of construction and the dynamism of manufacturing activities have boosted demand in the loanable funds market in parallel to that observed in the real sector of the economy. In the case of manufacturing, investment opportunities due to the nearshoring phenomenon, as well as the resilience of external demand, could imply an even greater momentum in the regions where this type of production takes place in the medium term.

According to our analysis, the dynamism of investment in 4Q22 could explain an expansion in business demand for loanable funds, even in an inflationary environment and with the underlying component peaking during that period, along with the growth of consumption, which contributed to increase income flows, while that of imports is consistent with a greater need for financing.

The Central region has also registered the lowest dynamism among regions in 17 of the last 20 quarters, reflecting a decentralization of lending activity. This has been consistent with the economic growth of the other regions of the country, as well as the development of industry and population centers outside the Central region, leading to larger bank financing in parallel to the growth of the real sector of the economy in the rest of the country.

Events in foreign banks have had limited impact on the Mexican financial system

The Financial Stability Board (Consejo de Estabilidad del Sistema del Sistema Financiero - CESF) updated its balance of risks. Its statement highlights that the difficulties experienced by some banks in the United States and Europe have had a limited impact on the Mexican financial system, which continues to show resilience and a solid position reflected in its high levels of capital and liquidity. Although some non-bank financial intermediaries have faced difficulties due to the higher cost and lower availability of their funding sources, the sector has a small participation and a low interconnection with the financial system as a whole, so it does not represent a potentially systemic risk.

The CESF states that global risks to financial stability persist. These include uncertainty about the performance of the banking sector in some advanced economies, which could generate greater volatility. Global risks also include the risk of prolonged inflationary pressures, a worsening of geopolitical tensions and a further tightening of financial conditions. Finally, there is still a risk that the recovery process of the world economy may slow down due to a greater than anticipated deceleration. As for local risks, the risk of a further weakening of domestic demand persists, while exports could see their dynamism affected by the current environment.

Financial Markets

Uncertainty about future credit conditions opens up new discrepancy between Fed and market expectations

During the last few weeks, the uncertainty in the financial markets unleashed by the intervention of *Silicon Valley Bank (SVB)* has diminished, in light of the measures adopted by the authorities and given the wide dissemination and analysis of the particular characteristics surrounding the case of the Californian bank.

Although bank share prices are far from having returned to the prices observed before the intervention, their fall has been halted, whereas stock market volatility, as measured by the VIX index, has already returned to the levels observed at the beginning of March.

However, the SVB episode has left a new discrepancy of significant magnitude between the expectations for the federal funds rate (FFR) of market participants and those of FOMC members, released on March 22, which influences the valuation of several asset classes. At the close of the first week of April, FFR futures were discounting a cut of around 60 bps by the end of 2023, something that contrasts with the most recent projections by FOMC members and comments by the Chairman of the Fed, who claimed that he and his colleagues do not anticipate cuts for the remainder of the year.

What could market participants be pricing in that would justify such rate cuts expectations? The most likely answer, at the moment, is a significant tightening of credit conditions in the U.S. economy, which would increase the likelihood of a recession.

According to the Fed's Survey on Bank Lending Practices, financial institutions were already signaling tighter lending as early as 3Q22 and, judging by FFR futures prices, market participants believe that it will tighten much more as a result of the SVB episode.

In addition to the issue of bank credit, it is true that economic activity data for March (e.g., activity in the manufacturing and services sector, vacancies and employment) already show certain signs of weakness, although more related to the effect of interest rate increases than to the SVB incident. However, this weakness does not seem to be of such a magnitude as to justify several rate cuts in the remainder of the year.

This difference in expectations has had a significant impact on the valuation of various financial assets.

As in previous episodes, the expectation of FFR cuts and the increased likelihood of a recession translated into a widespread drop in the Treasury curve. The two-year curve dropped almost 100 basis points (bp) between February 28 and April 6, while the 10-year curve fell 62 bp in the same period. This increased the slope of the curve to levels observed at the end of 2022 (55 bp).

In Mexico, the persistence of services inflation, the cautious tone of some members of Banxico's Board of Governors, and a certain optimism associated with nearshoring, could have explained a smaller reduction in the yield to maturity of the 10-year MBono between February 28 and April 6 (49 bp) compared to its US counterpart, even though the variation of the 5-year CDS spread in the mentioned period was minimal (5 bp).

In the face of lower yields, most of the main stock indexes rose between February 28 and April 6, particularly technology stocks. Although it is worth noting that the largest proportion of these rises followed the Fed's meeting on March 22 (see Chart 1), which emphasized measures to reduce contagion in the banking system and signaled that a possible further tightening of credit going forward might make additional interest rate increases less necessary.

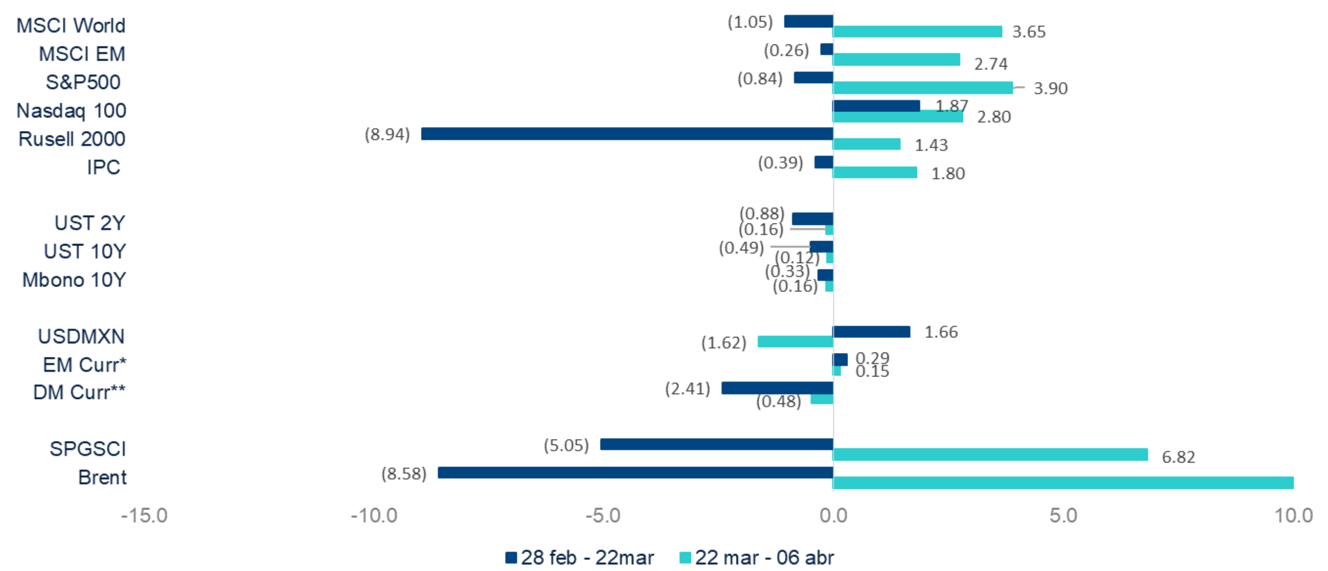
Notwithstanding the rises in the main indexes, between February 28 and April 6, banking sector stocks in both the United States and Europe suffered significant losses ranging from 21% to 30% (see graph 1). However, without a doubt, the greatest losses were concentrated in the US regional banks, with a fall of 41.3% over the same period.

In the foreign exchange market, the dollar's gains in the face of increased risk aversion were reversed after the FED meeting and the U.S. currency finally retreated against the currencies of emerging and developed economies between February 28 and April 6. The Mexican peso appreciated during the latter part of the aforementioned period, which more than offset the initial depreciation. The exchange rate closed the first week of April once again below 18.3 pesos per dollar.

In short, the expectation of significant interest rate cuts among market participants not only disagrees with the Fed's projections, but also with the data observed at the moment. The macroeconomic scenario consistent with cuts of such magnitude requires a rapid and severe tightening of credit conditions, which does not coincide with the behavior observed in recent weeks for some asset classes.

Consequently, a new correction in the prices of risk assets in the coming months cannot be dismissed, to the extent that the economic scenario validates or not the expectations implicit in current prices.

Graph 1. **PERFORMANCE OF MAJOR FINANCIAL ASSET PRICES, DURING MARCH AND APRIL 2023 (% VARIATION IN LOCAL CURRENCY)**



Source: BBVA Research, information from Bloomberg.

*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 country currencies.

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