Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

Real business financing balances decrease in dynamism

In May 2023, the balance of the performing loan portfolio granted by commercial banking to the non-financial private sector (NFPS) registered a real annual growth of 4.5% (10.6% nominal), a smaller increase than in the previous month (5.1% in April 2023). Nominal annual rates showed signs of a slowdown in all portfolios, but in real terms, the business portfolio was the only one to record lower growth for the second consecutive month. In the fifth month of the year, consumer credit contributed 2.5 pp to the 4.5% real annual growth, while the housing and corporate portfolios contributed 1.2 and 0.9 pp, respectively.

Outstanding consumer credit registered real annual growth of 11.4% (17.9% nominal), maintaining an upward trend that began in January 2022. The credit card and payroll loans segments (37.6% and 26.4% of the consumer portfolio, respectively) being the main drivers behind this recovery, with a real growth of 14.7% and 10.8%. Financing for the acquisition of durable consumer goods (ADCGs, 15.9% of consumer loans) increased by 9.1% in real annual terms, whereas personal loans (15.8% of the consumer portfolio) registered a real annual change of 6.4%. Employment indicators and the total wage bill continue to be the main drivers of this dynamism.

The housing portfolio recorded an annual growth rate in real terms in March of 5.1% (11.2% nominal). The May result shows a greater dynamism in this portfolio for the fourth consecutive month, due to the greater dynamism in the medium-residential housing segment, and to the lower magnitude of the year-on-year fall in the balances of loans for low-income housing. The good performance of the labor market in 2022, as well as the low unemployment rate, are factors that have boosted the demand for this type of financing, especially if interest rates are expected to show a downward trend in the medium term.

Business credit (54.1% of the outstanding portfolio to the NFPS) registered a real growth of 1.6% (7.6% nominal), a slowdown for the third consecutive month. In May, the dynamism of this portfolio also decreased in monthly terms (0.1% vs. 1.0 average in April 2023). Higher interest rates, as well as lower business revenues (for example, ANTAD's total store nominal sales indicator contracted 1.7% y/y in real terms in May) appear to have already dampened demand for this type of financing.

Inflationary convergence and lower interest rates could still stimulate demand for business credit in the medium term, although it is necessary for investment indicators to register a momentum above that recorded in recent months, as well as for employment and wages to continue to perform well in the case of household loan portfolios.

Term deposits were the main source of momentum for traditional bank deposits in May

In May 2023, the balance of traditional bank deposits (demand + term) barely registered a positive real annual growth rate of 0.1% (5.9% nominal), its second positive real growth after the declines observed in 1Q23, which reached its lowest in February 2023 with a contraction of -1.5%. Term deposits contributed 2.63 pp to the dynamism reported in May, which was marginally above the 2.57 pp drop associated with sight deposits. Term deposits have consolidated their position as the main source of dynamism in traditional fundraising over the course of 2023, as evidenced by their increase in the share of traditional fundraising of 1.5 pp in the first five months of the year (from 33.1% of the total in December 2022 to 34.6% in May 2023).

Sight deposits registered a real annual change of -3.8% (1.8% nominal), leading to five consecutive months of decreases. Part of this drop is due to the negative impact of the ongoing valuation of balances denominated in foreign currency (F.C., 13.3% of total sight deposits), which have fallen because of the appreciation of the exchange rate. The reduction in the dynamism of these instruments is also attributable to a substitution effect, as savers have opted to allocate part of their resources to longer-term instruments and investment funds, due to the higher returns offered.

In the analysis by holder, sight deposits of companies reported a 5.9% drop in real annual terms in May, while for individuals the drop was 5.3%. This drop was greater for companies, but smaller in the case of individuals compared to the previous month (4.5% and 6.4%, respectively). The dynamism observed in domestic consumption, together with the sustained growth of real wages (which increases part of the working capital costs for companies) could explain the observed decumulation of liquid resources so far this year. Despite the decrease observed in the total balance of sight deposits in the first months of 2023, it is noteworthy that, after discounting the accounting effects of inflation and the exchange rate, the balance of sight deposits is still 17.5% above the level observed in February 2020.

In the case of term deposit balances, they registered a real annual growth of 8.2% (14.5% nominal) in May 2023, accruing six consecutive months of recovery, despite the fact that, like sight deposits, the valuation effect of the exchange rate (12.0% of the balance of these deposits is denominated in F.C.) diminished their dynamism. This good performance is directly associated with the cycle of rising interest rates in an environment of economic growth, which has increased the relative attractiveness of this type of savings instrument.

Among term deposit holders, the balances held by individuals stand out as these reached a real annual growth rate of 13.7% in May, the seventh consecutive month with double-digit growth in real terms, something not seen since 2018. Meanwhile, companies recorded a 4.4% annual increase in their term deposit balances. Moving forward, a high interest rate environment anticipates a period in which balances of this type of savings will continue to consolidate their recovery from the deep decline experienced during the pandemic. Stripping out the effect of inflation and the exchange rate, the balance of term deposits is still 6.6% below the level observed in February 2020.

Lastly, among the financial savings alternatives offered by banks, the favorable performance of debt mutual funds (DMFs) stands out as these reported a real annual variation of 13.6% in May, making 11 months of growth and achieving double-digit figures for the third month in a row. High yields in an environment of exchange rare appreciation and low volatility have helped to encourage inflows into this type of instrument.

The financial system maintains sufficiently solid fundamentals to face stress scenarios: Financial Stability Report

In an environment of high uncertainty characterized by tightening financial conditions and events of instability (e.g., bank failures in the United States and Europe, discussions on the U.S. debt ceiling), Banxico's Financial Stability Report - First Half 2023 (REF) concludes that the Mexican financial system and, in particular, commercial banks maintain a strong position with solid and resilient fundamentals.

In particular, with respect to commercial banks, the REF notes that during 4Q22 and 1Q23, bank assets (both credit and securities transactions) continued to recover, accompanied by growth in deposits, particularly in the term deposit component. Given the current tightening cycle and due to the sensitivity of the loan portfolio and the different types of deposits, the balance sheet for commercial banks shows an equilibrium between assets and liabilities, meaning that rate adjustments have had a limited effect. Likewise, increases in the portfolio have been lower than the total funds raised by commercial banks.

In terms of solvency, **commercial banks are maintaining capitalization and liquidity levels above the regulatory minimum**, with the Capital Ratio Index (ICAP) registering 19.3% in Mar-23, 55 bp above the Sep-22 figure, as a result of an increase in fundamental capital greater than the increase in assets subject to credit and operational risk.

With respect to the profitability of commercial banks, the ROE maintains a growing trend and in Mar-23 showed an increase in comparison with the last REF. Higher net interest income and intermediation income compared to administrative expenditure and loan loss provisions account for this performance. In addition, there is a trend to return to pre-pandemic levels, as credit growth shows a slowdown and the same return to pre-pandemic growth.

The IMORA (Non-performing loans plus write offs) indicator shows that, although it is at low levels, the distribution of the growth rate reveals high levels of uncertainty. Related to this point, the REF highlights that, although total household leverage remained at similar levels in March 2023 to those observed a year earlier, **the financial burden of commercial bank borrowers in the form of credit cards as a percentage of their income increased significantly**.

For the other institutions in the system, the **distinct behavior of debt and equity mutual funds against the backdrop of higher interest rates is of note**. According to the REF, as of the first half of 2023, debt mutual funds (DMF) increased their assets by 13.3% nominal, while equity funds (EMF) showed a reduction of 0.9%. The increase in DMF assets came from both valuation gains and inflows, which, particularly during 2023, amounted to MXN 164 billion.

It is significant that this trend of inflows to DMFs started toward the end of the first quarter of 2022, which coincides with the increase in the U.S. federal funds rate and the drop in investment flows to EMFs.

Within this context the REF considers the following **risks to financial stability**:

1. Tightening of greater magnitude and longer duration. This could translate into increases in risk premiums and disorderly adjustments of portfolio flows to emerging economies, in addition to increasing the probability of the occurrence of one-off events that jeopardize global financial stability.
2. Lower-than-anticipated global economic growth and a downward trend. Influenced by the tightening of financial and credit conditions in developed economies, this risk could result in higher credit risk for financial institutions.

3. Occurrence of a systemic event affecting the global financial system. In the first instance, this type of event is reflected in greater risk aversion and volatility in the financial markets, but may have effects on economic growth through adverse effects on the intermediation of resources.
4. Weakening of aggregate demand at a domestic level. Given the weakening of growth expectations going forward, there is a risk that the consumption and investment dynamics will decrease significantly, with consequences on the system's intermediation income and increases in credit risk.
5. Additional adjustments to sovereign and Pemex credit ratings. Although there has been an orderly management of public finances, the risk that extraordinary fiscal support for Pemex and CFE may be necessary is not ruled out.

Finally, when assessing the impact of macroeconomic scenarios consistent with these risks, in addition to four historical scenarios (the 1995 crisis, the 2008 global financial crisis, the Taper tantrum and the COVID-19 crisis), the REF concludes that, at an aggregate level, the financial system is resilient to the shocks considered and maintains its solvency levels above the regulatory minimum for the stress horizon (36 months).

However, the REF warns that some banking institutions would indeed end the stress horizon with capitalization levels below the regulatory minimum, although these represent a small proportion of the system's assets.

Outstanding loans increased in the Central region in 1Q23, more than offsetting slower growth in the rest of the country

According to Banco de México's Regional Economies Report for January - March 2023[1], based on the Credit Market Conjunctural Evaluation Survey (EECMC) corresponding to 1Q23, the outstanding portfolio of non-financial private companies in commercial banking presented a real annual growth[2] of 3.2% in the first quarter of the year, a similar dynamism to that recorded in 4Q22, when it grew by 3.0%.

Bank credit in the Northern region, which represents 23% of credit, contributed 1.42 of these 3.2 pp, while 1.15 is attributable to the North Central region, 0.83 to the Central region, and -0.26 to the Southern region, highlighting that the Central region was the only one that increased its dynamism in quarterly and annual terms, with a real annual change of 1.5% (vs. -2.2 in 4Q22 and -6.0% in 1Q22).

By type of activity during 1Q23, the outstanding portfolio of the primary sector only grew in the North Central region of the country, with a real annual change of 5.6%. By contrast, the performing loans to the agricultural sector in the Center registered a contraction of 6.5%, while in the North and South regions, the decreases were 5.3% and 2.6%, respectively.

In the case of industry, the greatest dynamism in 1Q23 was recorded in the North Central region, with a real annual variation of 8.6%. Industrial financing in the Central region increased 3.1%, while in the South and North regions, outstanding industrial loans contracted by 2.8% and 1.0%, respectively. In services, the South experienced a 4.5% drop in real outstanding balances. The portfolio for tertiary activities registered greater dynamism in the North (17.2% real annual growth), followed by the North Central (5.8%) and Central (0.6%) regions, which presented weaker dynamism than in 4Q22.

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.

Total corporate financing presented a slightly higher real annual growth rate than in the previous quarter, but credit dynamics reflect a greater dynamism in the Central region, explained by the growth of outstanding balances in industry in the North Central and Central regions, as well as in services in the North and North Central regions.

The reactivation of construction and the growth in manufacturing activities, even if these recorded lower growth than in 4Q22, have continued to drive demand for corporate credit. Investment opportunities in view of the current expectation of industrial growth due to nearshoring could have implied a boost in industrial financing.

According to our analysis, the greater strength in investment in 1Q23 and a downward inflationary convergence trajectory are factors driving demand for business credit. Additionally, the higher average annual growth of consumption in the domestic market during 1Q23 would have contributed to an increase in corporate income.

2. Financial Markets

Mexican peso and technology stocks among the top performers in the first half of 2023

Among all the narratives constructed at the beginning of 2023, two main trends seem to have shaped the price movement of major asset classes during the first half of 2023. First, a more resilient global economy than expected, particularly with regard to the US labor market.

Recession expectations have been postponed throughout the year and with it, the scenario of a *soft landing* has become increasingly likely among market participants. This is in the wake of better-than-expected economic activity data, especially for private consumption in the first quarter, which, despite showing signs of a slowdown, is far from what would have been expected given the magnitude of the current restrictive monetary cycle.

The second is an increase in the demand for services relative to the demand for goods following the gradual fading of the effects of the pandemic. Supported by the remnants of the extraordinary fiscal aid received during the pandemic, consumption of services in several developed countries has remained very strong, which has been reflected not only in the resilience of economic activity as a whole, but also in the persistently high core inflation. This fact means that inflation risks remain skewed upward, which maintains the restrictive stance of the world's main central banks.

So, against a backdrop of solid economic activity, especially in the United States, and low risk aversion (the VIX index closed at 13.6% in June), the main stock indexes recorded widespread gains. In the first half of 2023, the benchmark for this asset class (*MSCI World*) rose by 14.0%, which is explained to a greater extent by the North American indices and less by the European and emerging market indices (figure 1).

The Nasdaq index of technology stocks deserves special mention, whose growth of 31.7% is the highest for a similar period in its history and can be explained by the great interest among market participants in the subject of artificial intelligence. This was evidenced by a rise of around 196% during the first half of the year in the share price of NVIDIA, the manufacturer of graphics processing units.

The commodities market, meanwhile, reflected lower demand for goods, given the fading of bottlenecks and lower-than-expected growth in China following the post-pandemic reopening. The benchmark for this asset class recorded losses of 11.4% during the first half of 2023, with declines for practically all of its components and a

15.0% drop in the energy sector. It should be noted that the Mexican oil blend only declined by 6.6% over the same period, which was even less than the 12.8% drop in Brent.

In contrast to what happened with goods, the increase in demand for services was reflected in a greater persistence in the core inflation indexes at a global level with the consequent monetary tightening. This resulted in higher short-term interest rates and curves with negative slopes.

In the case of Treasury bonds, during the first half of 2023, the two-year tenor rose 47 basis points (bp), while the 10-year tenor fell 4 bp, causing the slope to close June at -1.1%, the lowest since the early 1980s (figure 1). Regarding Mexico, the 10-year tenor fell 36bp during the first half of the year, supported by the end of Banxico's tightening cycle and a significant drop in inflation during the second quarter of 2023. In the aforementioned period, the monetary policy rate increased 75bp.

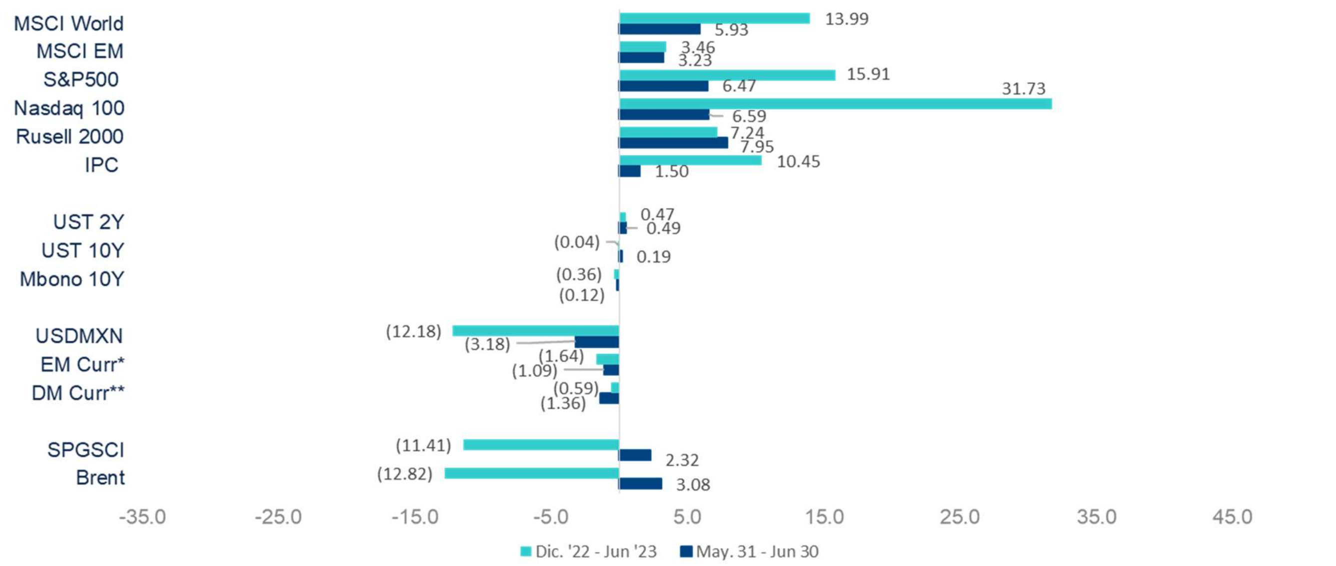
Throughout the first half of the year in the foreign exchange market, there were expectations of a change in the monetary policy stance (FED pivot) due to the risk of recession on several occasions, which influenced the weakness of the dollar. In general terms, the U.S. currency lost 1.6% against emerging economies (EM) currencies and 0.6% against developed market currencies (graph 1).

The Mexican peso's performance was undoubtedly outstanding, appreciating 12.2% during the first half of the year to become the third most appreciated currency among its EM peers. With this appreciation, the exchange rate closed June at 17.1 pesos per dollar, its lowest level since 2017.

Behind the better-than-expected performance of the peso are: the high interest rate differential with respect to its U.S. counterpart; the low implied volatility of the Mexican currency; the positive differentiation of Mexico with respect to its Latin American peers in political and fiscal matters; and the favorable investment expectations for Mexico derived from the nearshoring issue.

Consequently, the main unknown for the second half of the year remains the extent to which the Fed will be able to bring U.S. inflation toward its target without generating high costs in terms of unemployment and financial stability. At the moment, and after a hike cycle of more than 500bp, there are still no clear signs of a near convergence of inflation to the 2.0% target, which means that the hike cycle has not yet come full circle. To the extent that there are clues of solution to this unknown, and this is incorporated into market expectations, the price performance of risk assets could consolidate or reverse, to a certain extent, the results observed during this first half of the year.

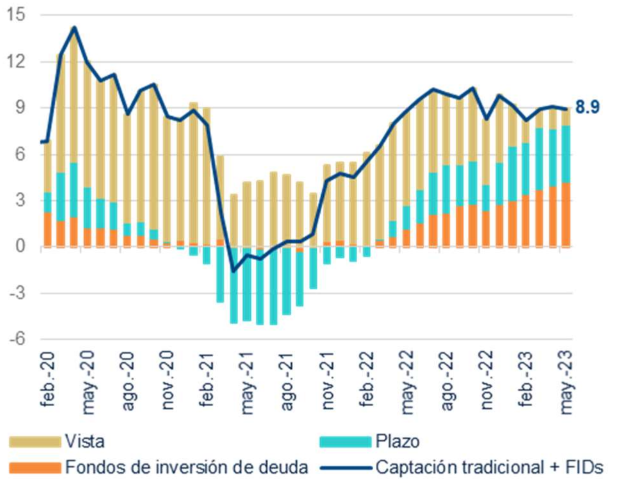
Figure 1. **PRICE PERFORMANCE OF THE MAIN ASSET CLASSES DURING THE FIRST HALF OF 2023** (% CHANGE IN LOCAL CURRENCY)



*JP Morgan Emerging Markets Currency Index. For this index a reduction (increase) implies a depreciation (appreciation) of a basket of emerging market 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 based on Bloomberg data.

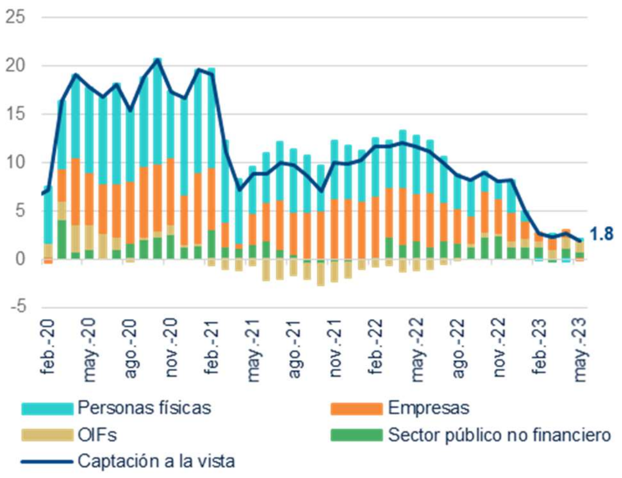
Deposits: figures

Figure 2. **COMMERCIAL BANKING DEPOSITS (NOMINAL ANNUAL CHANGE, %)**



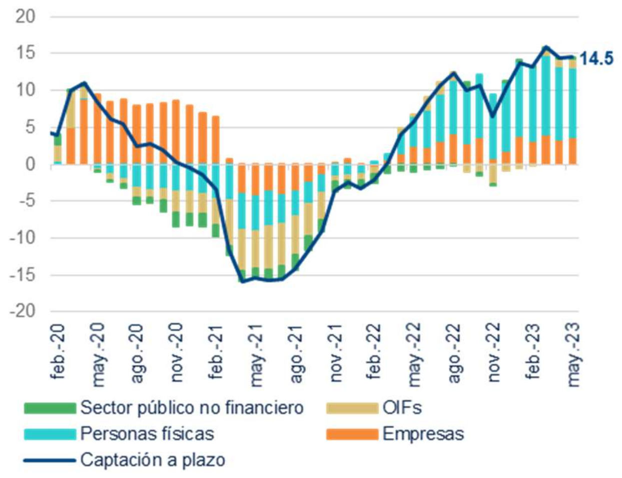
Source: BBVA Research based on Banxico data.

Figure 3. **SIGHT DEPOSITS (NOMINAL ANNUAL CHANGE, %)**



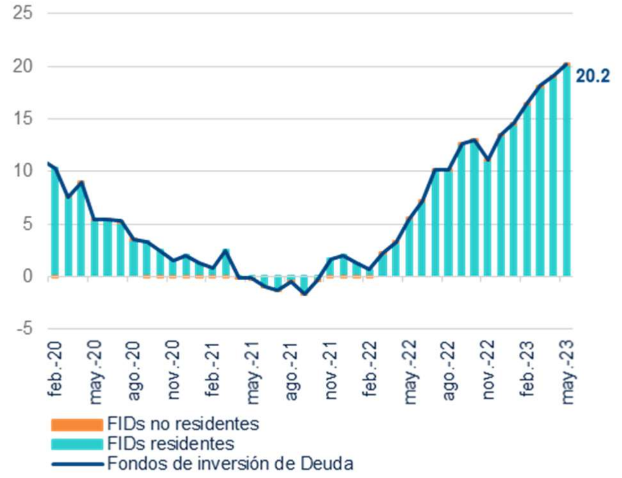
Source: BBVA Research based on Banxico data.

Figure 4. **TERM DEPOSITS (NOMINAL ANNUAL CHANGE, %)**



Source: BBVA Research based on Banxico data.

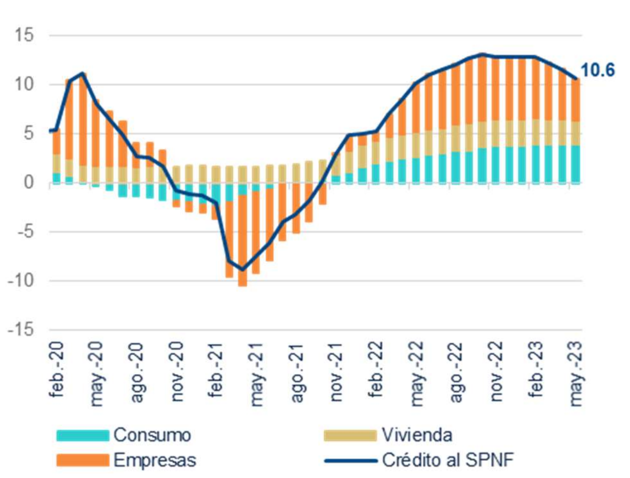
Figure 5. **DEBT INVESTMENT FUND SHARES (NOMINAL ANNUAL CHANGE, %)**



Source: BBVA Research based on Banxico data.

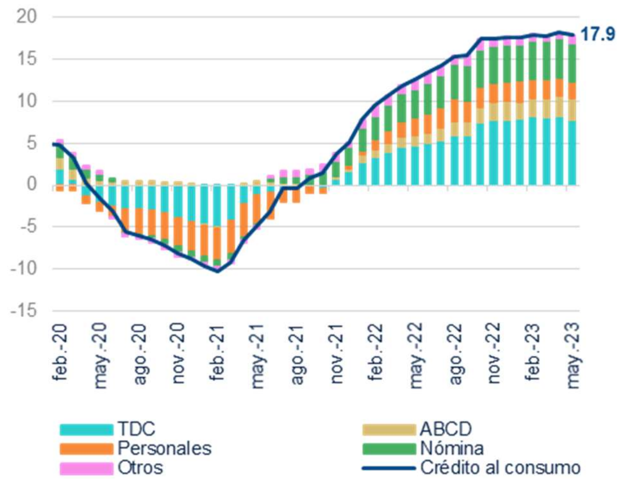
Credit: figures

Figure 6. **OUTSTANDING BANK CREDIT TO THE NON-FINANCIAL PRIVATE SECTOR**
(NOMINAL ANNUAL CHANGE, %)



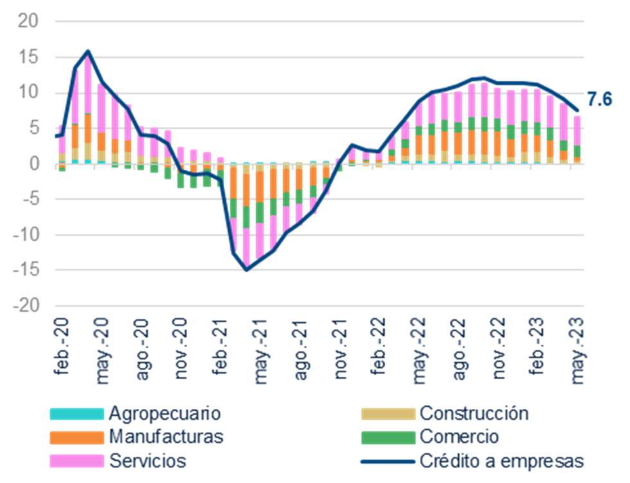
Source: BBVA Research based on Banxico data.

Figure 7. **OUTSTANDING CONSUMER CREDIT**
(NOMINAL ANNUAL CHANGE, %)



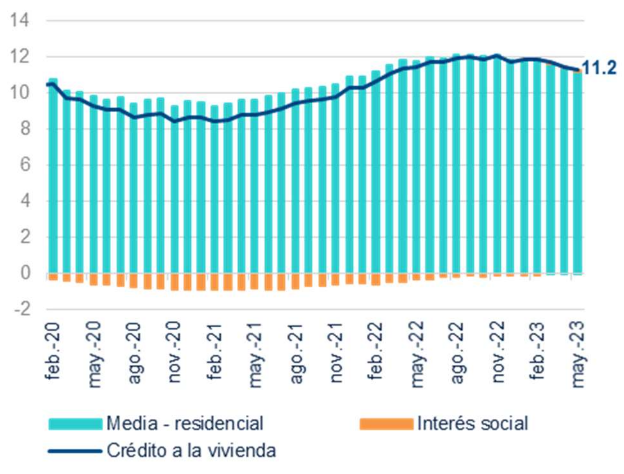
Source: BBVA Research based on Banxico data.

Figure 8. **OUTSTANDING BUSINESS LOANS**
(NOMINAL ANNUAL CHANGE, %)



Source: BBVA Research based on Banxico data.

Figure 9. **OUTSTANDING MORTGAGE LOANS**
(NOMINAL ANNUAL CHANGE, %)



Source: BBVA Research based on Banxico data.

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