Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

Traditional bank deposits stabilized term deposits maintained real growth in double digits

In October 2023, the balance of traditional bank deposits (sight + term) registered a real annual growth rate of 4.5% (equivalent to a nominal growth of 9.0%), similar to the growth observed in the previous month (4.7% real). For the third consecutive month, sight deposits continued to contribute positively to the dynamism, contributing 1.1 pp to the 4.5% growth of traditional deposits, while term deposits remained the main source of dynamism, contributing 3.4 pp.

sight deposits (65% of traditional bank deposits) grew at a real annual rate of 1.7% (6.0% nominal) in October, the same as in the previous month. Although the aggregate remained dynamic, the performance by holder was differentiated. The recovery in sight deposits held by non-bank financial intermediaries (6.6% of sight deposits) continues to be significant, reaching an annual growth rate of 30.7% in October, the highest growth rate recorded so far this year. In contrast, balances associated with the non-financial public sector (11.2% of the total) reduced their dynamism at a real annual rate of 5.1% (vs. 19.3% in September). The dynamism of these two segments was sufficient to offset the contraction observed in the private sector sight deposits. In particular, sight deposits of companies recorded a 0.3% real y/y fall (lower than the 1.4% growth observed in September), while the deposits of individuals showed, for the eleventh consecutive month, a contraction that amounted to 0.7% y/y in real terms, the most moderate so far this year. Although this reduction in the private sector's sight balances has been associated with a recomposition of its savings toward instruments with higher yields, the sustained dynamism observed in private consumption could also be contributing to the reduction in the balance of liquid instruments in this segment.

In the case of term deposits, their dynamism decreased in October, registering a real annual growth rate of 10.2% (14.9% nominal), lower than the 10.6% real growth rate observed in September. As in the case of sight deposits, non-bank financial intermediaries and the non-financial public sector (which together represent 16.2% of term deposits) saw improved performance, as their term deposits grew at real annual rates of 14.4% (y/y vs. 12% in September) and 0.3% (vs. -33.4% in September), respectively. In contrast, the growth of term deposits of the non-financial private sector moderated. In the case of companies, such deposits registered a real annual growth rate of 5.9% in October, lower than the 8.8% observed in the previous month. Meanwhile, term deposits of individuals grew at a real annual rate of 12.3%, below that recorded in September (13.1%), but remaining for the twelfth consecutive month in double-digit territory. The high interest rate environment has maintained the attractiveness of term savings instruments, so a period in which interest rates remain high anticipates that the good performance of term deposits will continue in the short term.

Credit to the non-financial private sector increased its dynamism in October, despite the slight slowdown of credit to households

In October 2023, the balance of the outstanding loan portfolio granted by commercial banking to the non-financial private sector (NFPS) registered a 5.9% real annual growth rate (10.4% nominal), slightly higher than the 5.8% recorded in the previous month. Household credit - consumption and housing - presented a lower dynamism with respect to September, both in nominal and real terms. The corporate portfolio recorded a better performance only in real terms. This implies that consumer credit contributed 3.0 pp to October's 5.9% real annual growth, while the corporate and housing portfolios contributed 1.7 and 1.2 pp, respectively.

In October, the outstanding consumer loan portfolio grew by 13.4% in real annual terms (18.2% nominal), which represents the first slowdown so far this year. Balances in the credit card (CC) and payroll loans segments (37.7% and 25.9% of the consumer portfolio, respectively) recorded real growth rates of 16.0% and 10.2%, below those observed in September. In contrast, credit for the acquisition of durable consumer goods (ADCGs, 15.9% of consumer credit) increased 14.6% in real annual terms, while personal loans (15.8% of the consumer portfolio) registered a real annual variation of 9.3%, a higher dynamism than that of the previous month. The performance of the consumer portfolio is consistent with the growth of formal employment (although with a slight slowdown in October) and real wages, these being variables closely related to private consumption, and which foster an expansion of credit demand in this portfolio.

The housing portfolio registered an annual growth rate of 5.0% in real terms in October (9.5% nominal), which represents the third consecutive slowdown of this portfolio with respect to the previous month and is partly the result of the performance of the low-income housing segment, which registered a real contraction significantly higher than that observed in the previous month (-6.0 vs. -2.7% in the previous month). Likewise, middle-income residential housing financing balances grew by 5.5% real y/y, a slight slowdown with respect to the previous month (5.6% real y/y). The lower dynamism of housing loan balances could be the result of high long-term interest rates, which, together with residential real estate inflation, represents a deterrent to mortgage loan demand.

Business loans (53.6% of the outstanding portfolio to the NFPS) registered annual growth of 3.2% in real terms (7.6% nominal), a greater dynamism than that observed in the previous month. With respect to the performance of balances by business sector, the manufacture of transportation equipment and real estate services stand out, contributing 2.7 and 2.4 pp to growth, respectively, followed by trade (1.9 pp) and professional services (1.1 pp), the balances of which are the main drivers of portfolio growth, despite the declines observed in other activities.

In the case of trade, revenues could explain the demand for bank financing. In particular, revenues from the supply of goods and services from wholesale trade grew at a real y/y rate of 7.1% in September (latest available information), while those from retail trade slowed slightly. Likewise, in October there was a slight real slowdown in ANTAD total store sales (2.1% vs. 3.2% the previous month), which could explain the relative slowdown in demand for financing. As for the growth in the real estate services sector, this could be reflecting the willingness of companies to take advantage of the nearshoring phenomenon. This relocation could also be boosting lending to private construction, the balances of which have already recorded two months of real annual growth, after 34 months of contraction. However, other manufacturing sub-sectors, the agricultural and electricity, water and gas sectors, as well as telecommunications and hospitality services continue to show falls in their commercial banking credit balances.

Although the dynamism of employment and wages have been the driving forces behind the growth of lending to the NFPS as drivers of loans to households, it seems that investment, with a certain lag, has positioned itself as one of the main variables in the increase in balances, due to the expansion of business demand for loanable funds. It also

highlights that the negative impact of higher interest rates on the growth of loans has not been enough to counteract the positive effect of the performance of real variables. Sustained growth of loans to the NFPS will depend on the good performance of the real sector of the economy, as well as on financial conditions that make it possible to take advantage of the opportunities of the current economic environment, with phenomena such as nearshoring and inflationary convergence.

Banks are anticipating higher demand for loans to companies and financial institutions, despite tighter lending conditions

Banco de México published the "Survey on General Conditions and/or Standards in the Banking Credit Market" (EnBan) for the July-September 2023 quarter. For 4Q23, commercial banking as a whole anticipate on average an increase in the demand for business loans to large non-financial companies and non-bank financial intermediaries. While the banks with the largest market share do not anticipate significant changes in the demand for credit through cards, non-financial SMEs and mortgages, the banks with the smallest market share expect, on average, an increase in the demand for these three segments. In terms of expectations regarding general conditions and/or credit approval standards for 4Q23, both groups of banks anticipate tighter conditions in the large non-financial corporate and non-bank financial intermediary segments. Banks with higher participation also expect tighter conditions in the credit card segment and similar conditions in the non-financial SME and mortgage segments. In contrast, banks with lower participation anticipate better conditions for credit cards, a tightening of approval standards for loans to non-financial SMEs and similar conditions for mortgage loans.

In this edition, EnBan includes a set of specific questions on the impact of nearshoring on bank credit to businesses. Among the results of this exercise, commercial banking as a whole reported on average that the demand for credit from large companies increased in the last 12 months and attributed part of this increase to factors related to the relocation of production. In the SME lending segment, on the other hand, the banks with the largest share did not perceive an increase in demand that could be attributed to relocation. In addition, banks report that the sectors in which they have observed on average a higher demand for credit associated with relocation are manufacturing, services and construction. Of particular note is that banks as a whole anticipate that relocation will have a positive impact on the demand for business loans to both large companies and SMEs over the next five years.

Increased use of bank financing among companies

The results of Banxico's Credit Market Survey for 3Q23 show that although banks remain the second largest source of financing for companies, they have gained ground over suppliers. In the reference quarter, 29.3% of the companies that used some type of financing obtained it from commercial banking, a higher percentage than the 26.5% recorded in 1Q23. Meanwhile, 58.1% of companies obtained supplier financing in 3Q23, lower than the 61.2% observed in 1Q23. The survey also reveals that a higher percentage of companies expect to apply for financing through commercial banking in 4Q23 (22.3% vs. 19.4% in the previous quarter).

The percentage of companies that used new bank credit increased to 15.2% in 3Q23 (higher than the 14.8% reported in the previous quarter). As for the use of new bank credit, working capital continues to be the most frequent use (65.2% of the companies stated that it was used for this purpose). In addition, in 3Q23 there was an increase in the percentage of companies that reported using financing for foreign trade operations (from 1.6% in 2Q23 to 10.9% in 3Q23) and for investment (from 23.3% to 27.5% in the same period).

Regarding conditions for accessing bank credit, in 3Q23 the companies surveyed perceived more favorable conditions with respect to the previous quarter regarding terms and amounts offered, but less favorable in terms of resolution times, refinancing conditions, collateral requirements, fees and interest rates.

In the face of a complex and uncertain global macrofinancial environment, the Mexican financial system maintains a solid and resilient position: REF

In an environment of high volatility in financial markets and increases in long-term interest rates, largely as a result of instability events such as the prolongation of inflationary pressures and the worsening of geopolitical tensions (i.e., the war between Russia and Ukraine and in the Middle East), Banxico's Financial Stability Report - Second Half 2023 (REF) concludes that commercial banks and, in general, the financial system as a whole, remain solid and resilient.

In particular, with respect to commercial banks, the REF points out that during the first 9 months of 2023, bank assets - both credit and securities operations - continued to increase, although at a slower pace than in 2022. Likewise, on the liabilities side, deposit growth has been observed, particularly in its term component. Although the target rate has not varied since 1Q23, the banks' cost of funding increased during 2Q23 and 3Q23, showing a greater response to the target rate than in the previous cycle, as was the case with the loan portfolio, which is why such growth has been orderly and has not resulted in imbalances.

In terms of solvency, commercial banks maintain capitalization and liquidity levels above the regulatory minimum, with the Capitalization Index (ICAP) registering 19.3% in Sep-23, a level practically the same as in Mar-23, because of an increase in fundamental capital of similar proportion to the increase in assets subject to credit and operational risk.

Regarding commercial banks' profitability, ROE is at its highest level since 2008, although it decreased in the margin in Sep-23, reaching 18.6%, partially as a consequence of the expenses for the constitution of credit reserves. The reserves created for the commercial portfolio (mainly financial and governmental institutions) explain this increase in bank outflows. The REF highlights the heterogeneity in profitability among institutions, which would translate into different capacities among banking institutions to increase their reserves, continue their intermediation work and face future risks.

As for the adjusted delinquency rate indicator (IMORA for its acronym in Spanish), it is worth noting the rebound it has registered, as well as a high degree of uncertainty in the distribution of the index. In relation to this point, the REF highlights that, although total household leverage remained at similar levels in Sep-23 to those observed a year earlier, the financial burden of commercial bank borrowers through credit cards as a percentage of their income increased significantly, in parallel to a shift to lower levels in the case of the non-revolving portfolio.

For the other institutions in the system, as in the previous issue of the REF, the distinct behavior of the fixed-income and equity mutual funds in the context of higher interest rates is striking. According to the REF, during the second half of 2023, fixed income funds (FRF) increased their assets by 9.4% nominal, while equity funds (FRV) have remained virtually unchanged, as a result of heterogeneous returns and net flows close to zero. Nonetheless, the increase in FRF assets came from both positive yields and inflows, which, particularly during 2H23 (as of November 22), amounted to 176.3 billion pesos.

As for other non-bank financial intermediaries, the REF highlights that they continue to face challenges related to tighter financial conditions, especially in the non-regulated segment. The greatest challenge consists in refinancing its debt in conditions of greater risk aversion among investors, which is partially the result of the default of some

entities, which has had reputational effects, together with the risk aversion stemming from the limited prudential regulation of these entities.

In general terms, the REF considers the following **risks to financial stability**:

1) A greater or more prolonged tightening than expected. This could translate into higher risk premiums and a disorderly adjustment of portfolio flows to emerging economies, which could also increase the probability of the occurrence of specific events that could jeopardize global financial stability.

2) A slowdown in the economy that is more pronounced or for a longer period of time. In conjunction with relatively tight credit and financial conditions in developed economies, this could mean greater credit risk for financial institutions.

3) Occurrence of a systemic event affecting the global financial system. In addition to greater volatility in financial markets and an increase in risk aversion, such events may affect the real sector of the economy through a lower availability of resources from intermediation.

4) Additional adjustments to sovereign and Pemex credit ratings. In addition to the fiscal and production implications, the cost of financing could be affected, thus implying a deterioration of the overall risk profile and the possibility of capital outflows from the country.

In addition, the REF presents an assessment of the impact of macroeconomic scenarios consistent with three of these risks and three historical scenarios (1995 crisis, 2008 global financial crisis and the economic crisis resulting from COVID-19). In conclusion, 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.

As in previous deliveries and stress exercises, the REF warns that some banking institutions could register higher capitalization impairments at the end of the stress horizon, although these represent a small proportion of the system's assets.

2. Financial markets

Are markets overpricing rate cut bets after the FED pivot?

For most of 2023, movements in financial markets were influenced by the degree of divergence between the Fed's interest rate expectations and those of financial market participants. In particular, it was not unusual throughout the year for communications from the Fed to attempt to temper the easing of financial conditions driven by market expectations with a bias toward pricing in several interest rate cuts over the next twelve months.

However, the messages of the last FED meeting of this year 2023 not only did not temper market expectations, but rather underpinned them and consolidated the *soft landing* scenario. For the first time since June 2020, members of the Federal Open Market Committee (FOMC) revised downward their interest rate expectations, with the median for 2024 pointing to an expected 75 basis points (bp) reduction in the federal funds rate, while 2025 points to an additional 100 bp cut.

It should be noted that last September most FOMC members still expected one more hike in the federal funds rate, while the anticipated cuts for 2024 and 2025 were 25 bp lower, respectively.

In addition, inflation expectations for year-end 2023 and the next two years were also revised downward, particularly this year, while forecasts for economic activity growth and unemployment registered marginal modifications and remain consistent with long-term estimates.

In short, the FOMC members incorporated a scenario in their projections in which the Fed manages to bring inflation dynamics toward its 2.0 percent target without generating a recession or major disruptions in terms of unemployment.

Against this backdrop of both the projections and the Fed's communication, the favorable reaction of risk asset prices consolidated what had already been initiated by previous inflation and unemployment data consistent with the *soft landing* scenario. The main stock indexes rose after the Fed meeting by between 1.6 and 6.3 percent for North American markets and by between 0.8 and 1.6 percent for European and emerging market indexes (see figure 1). It is worth noting the 4.8 percent rise in the CPI between December 11 and 14, which allowed it to accumulate a gain of 8.0 percent during the last month.

In line with this movement, in the U.S. fixed income market, the yield to maturity of the two-year Treasury bond fell 34 bp between December 12 and 14 to 4.38 percent, five basis points lower than the level recorded at the beginning of the year and far from its peak of 5.22 percent reached on October 18.

Lower short rate expectations, as well as lower inflation expectations, influenced a 28 bp drop in the yield to maturity of the 10-year Treasury bond between Dec. 12 and Dec. 14 (see figure 1). With this, in the last month this yield has been reduced by 61 bp and places the 10-year bond yield at 3.92 percent, a similar level to the beginning of the year and also far from the 4.99 percent of October 19.

Similar behavior was observed for the M10, even though Banxico's communication tempered expectations of a rate cut for the first meeting in 2024. Following the change in the Fed's expectations, the yield to maturity of this instrument was reduced by 35 bp, which at the close of December 14 was 9.06 percent, a level also very similar to that of the beginning of 2023 (9.04 percent) and 119 bp below its maximum of the year reached on October 25.

As expected, given this expectation of lower rates, the U.S. dollar weakened across the board, leading to gains of 1.2 and 1.8 percent between December 12 and 14 for emerging and developed market currencies, respectively. The Mexican peso appreciated by 0.7 percent during the period mentioned above, bringing the exchange rate to 17.2 pesos per dollar and putting the peso on track to close 2023 with an appreciation of around 12.0 percent.

However, given this change in the Fed's projections, the divergence with market expectations did not tend to close, but rather widened. Consistent with the federal funds rate futures market, financial market participants currently price in virtually 150 bp of cuts by 2024.

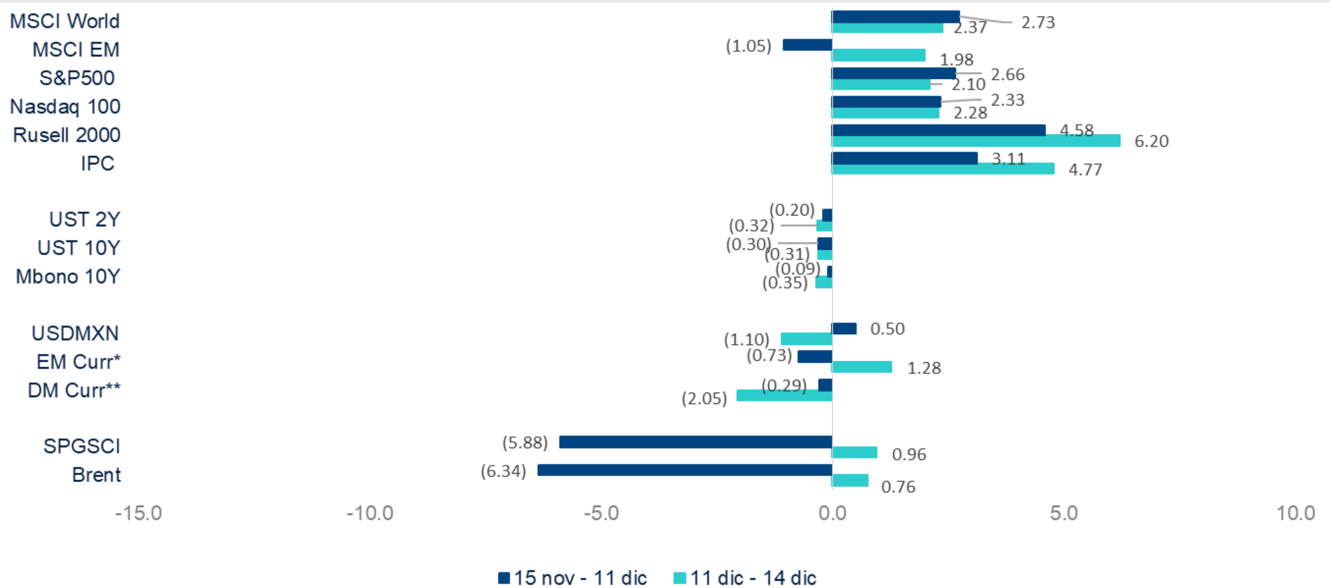
However, cuts of such magnitude in such a short period of time are not consistent with a *soft landing* scenario. In fact, expectations of cuts of such magnitude in the futures market have only been recorded in March 2023, after SVB's bankruptcy and a few months before the 2008 crisis. That is, the episodes in which rates have been reduced to such a degree in recent years have been more related to the need to cut in the face of a possible financial stress scenario than to the implementation of a *soft landing*.

In addition, earnings expectations for stock markets in the coming year are largely based on corporate earnings growth, which is difficult to associate with a scenario in which the monetary authority has to reduce the reference

rate by 150 bp. This is because scenarios with cuts of such magnitude are not usually favorable for increasing business profits.

In brief, market participants' interest rate expectations do not seem to be aligned with either the Fed's projections or with the discounted *soft landing* macroeconomic scenario itself. Again, it is to be expected that this divergence will tend to tighten in the coming months with a consequent increase in the volatility of risk asset prices.

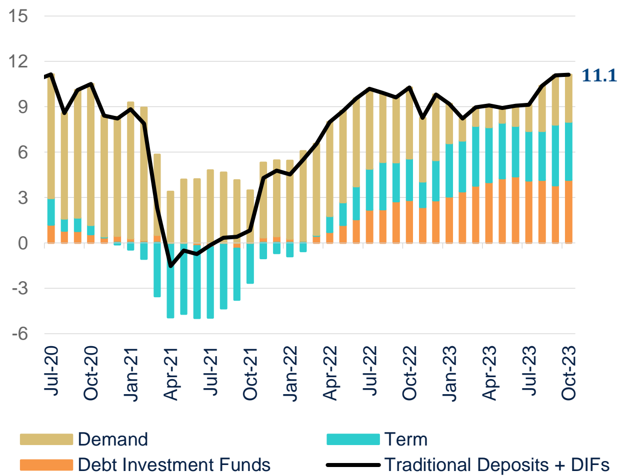
Figure 1. **PERFORMANCE OF MAIN FINANCIAL ASSET PRICES DURING NOVEMBER AND DECEMBER 2023** (% CHANGE IN LOCAL CURRENCY)



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

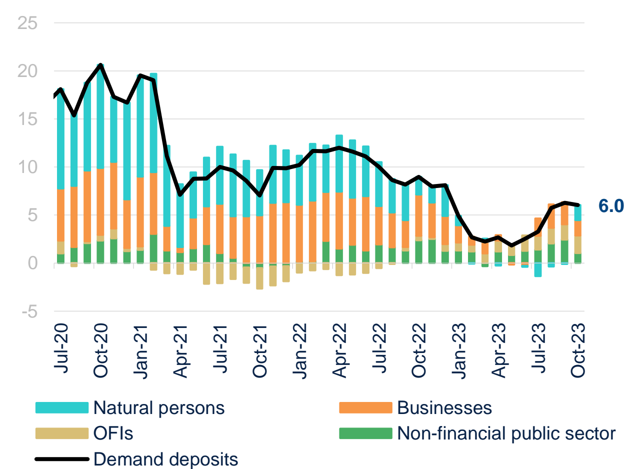
Funding: figures

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



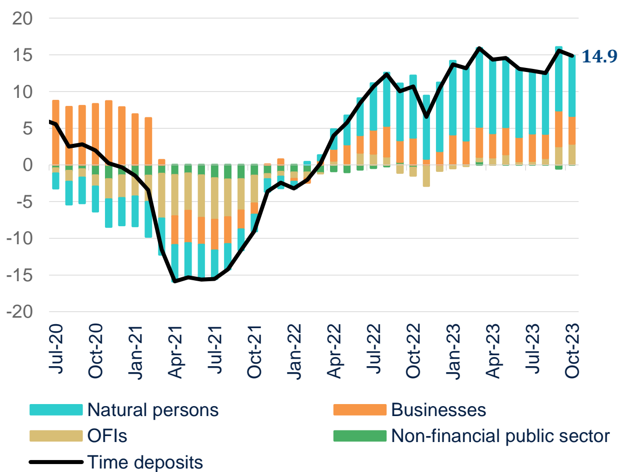
Source: BBVA Research based on Banxico data.

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



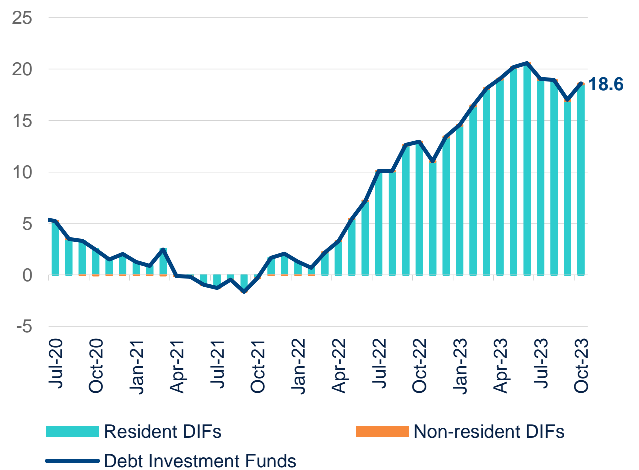
Source: BBVA Research based on Banxico data.

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



Source: BBVA Research based on Banxico data.

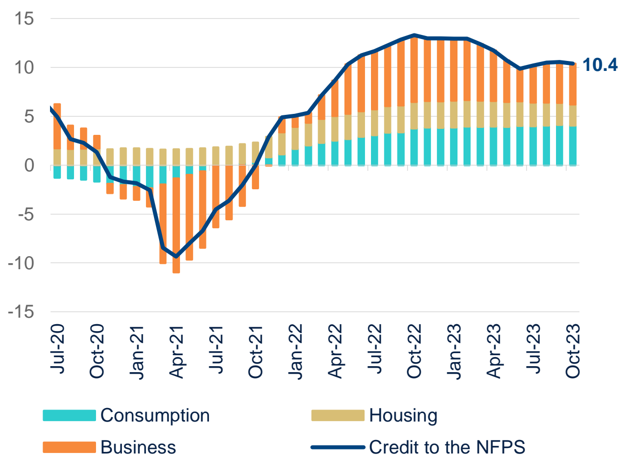
Figure 5. **DEBT INVESTMENT FUND SHARES**
(NOMINAL ANNUAL CHANGE, %)



Source: BBVA Research based on Banxico data.

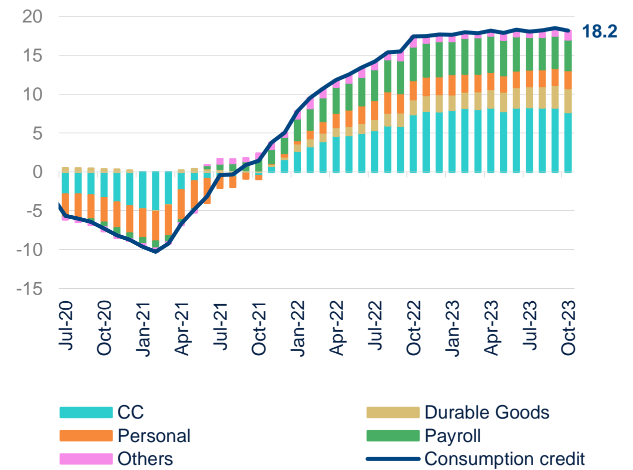
Loans: figures

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



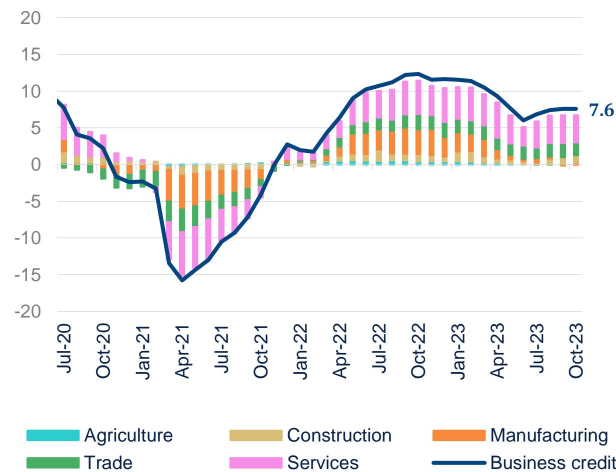
Source: BBVA Research based on Banxico data.

Figure 7. **PERFORMING CONSUMER LOANS** (NOMINAL ANNUAL CHANGE, %)



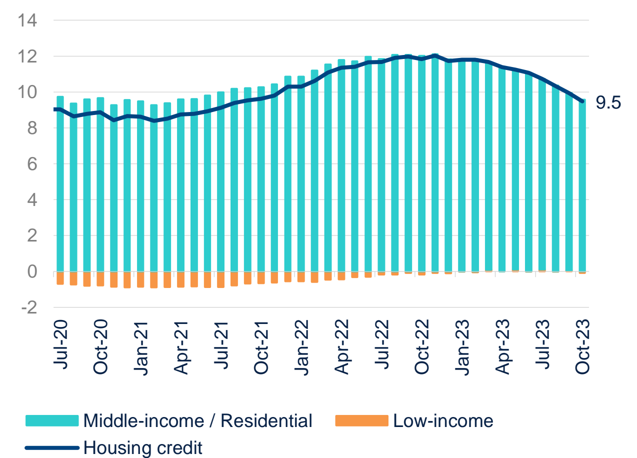
Source: BBVA Research based on Banxico data.

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



Source: BBVA Research based on Banxico data.

Figure 9. **PERFORMING HOUSING LOANS** (NOMINAL ANNUAL CHANGE, %)



Source: BBVA Research based on Banxico data.

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