Mexico Banking Watch

Bank of Mexico Report on the Financial System

On November 22 the Bank of Mexico (Banxico) released its September 2013 Report on the Financial System ("the Report"), pointing to the strength of the Mexican financial system but slower rates of growth, while also recognizing both domestic and external risks. The Report also examines forthcoming regulatory changes to OTC derivatives markets and the infrastructure of Mexican financial markets. The key aspects of the Report are as follows:

- **The international backdrop is one of weakness and uneven economic growth, shaped by the likelihood of monetary stimuli coming to an end in the United States.**

In the period covered by the Report (from October 2012 to September 2013), the international backdrop was characterized by moderate economic growth and numerous fiscal challenges in the United States, combined with expectations that the Federal Reserve would start to scale back its asset purchases. Meanwhile, the euro area recorded positive growth in the second quarter of 2013, although there is still plenty of uncertainty over the sustainability of its recovery and the sturdiness of its banks. The Report also highlights that some emerging economies such as China and India have suffered a significant slowdown, with a knock-on effect on other emerging economies via trade and their influence over international commodity prices. These events had a negative impact on international sovereign bond markets between May and August 2013, due to the increase in U.S. Treasury bond yields and a general outflow of capital from emerging economies. However, Mexican financial markets were not hit as hard as in other countries and the adjustments were more orderly.

- **At the domestic level, there was a notable slowdown in output during the first half of 2013, although macrofinancial fundamentals remained solid**

The decline in domestic demand was reflected in slowing industrial output, mainly in the manufacturing sector. Despite this, the Report points out that the current-account deficit held at moderate and easily financed levels. Furthermore, it points out that some economic indicators suggest that the slowdown affecting the Mexican economy will be temporary. For example, in 3Q13 GDP grew 0.84% on the previous quarter, while in 2Q13 it fell by 0.55%. Likewise, the Mexican financial system has benefitted from a favorable climate, based on low and stable inflation, as well as solidly anchored inflationary expectations.

- **The drop in economic growth rates led to slowing growth in demand for credit and an uptick in some risk indicators.**

The growth rate for credit to the non-financial private sector at the close of 2Q13 stood at 4.6% in real annual terms, compared with a rate of 10.2% in June 2012. Despite this, total private-sector finance as a proportion of GDP was above the long-term trend. Furthermore, the favorable trend from some credit risk indicators came to an end, including the probability of default and the NPA ratio. The Report states that a major proportion of the rise in the NPA ratio in the commercial portfolio was due to defaulting housing construction firms. In the consumer lending portfolio, deteriorating NPA ratios have mainly come in payday loans. In mortgage loans, credit for raising liquidity and paying liabilities had higher default rates than loans used to buy homes.

- **There has been an increase in market risks assumed by the leading intermediaries, although it has been mitigated by hedging strategies**

The increase was the result of the greater sensitivity of Mexican Federal Government debt to interest-rate fluctuations. This sensitivity had different consequences for the various financial intermediaries. For example, interest-rate changes had less of an impact on the portfolios of brokerage houses than on banks, as equity positions make up the bulk of their security portfolios. Furthermore, the uptick in market risk was mitigated by the growing use of hedging strategies, based on derivatives transactions by financial intermediaries. The report also highlights that as of June 2013 the Banxico stress index was relatively high, at similar levels to those seen in late 2009, and is yet to return to levels recorded prior to the international financial crisis.[1]

[1] Banxico's Financial Stress Index (FSI) is an indicator that summarizes 34 variables from the share market, debt market, forex market, derivatives market and banking market, as well as variables from domestic and international markets that may have an impact on the Mexican financial system and that are related with country risk.

- **Liquidity conditions in the domestic debt and foreign-currency markets remain stable, while the risk of contagion has declined.**

Despite increased international market volatility, transaction volumes on the currency markets remained high, with no abrupt changes to buy-sell spreads. The Report also points out that liquidity conditions in the national debt market have not changed by any significant degree, despite the decline in share positions for financial intermediaries as a result of a drop in appetite for risk and growing capital requirements for market risk. As for the risk of contagion, the Report points out that the exposure of the country's financial intermediaries to the rest of the world is limited. For example, for commercial banks' exposure to foreign entities represented 1.1% of their total assets as per September 2013.[2]

- **Household finance has grown at a slower pace, while business finance has expanded and has registered lower interest rates**

Household debt grew again, although growth slowed somewhat due to less buoyancy from consumer finance. As a result of the higher debt, debt servicing as a percentage of available income for households rose in 2Q13 against the same period in 2012 from 2.6% to 2.9%.

Non-financial corporate finance at the close of 2Q13 stood at 26.8% of GDP, with a 4.8% y/y real growth rate. The increase was the result of growth of both domestic finance (up 4.8% y/y in real terms) and foreign finance (up 4.6%) via debt securities markets and credit from financial intermediaries. In particular, the current portfolio of commercial banking loans to businesses grew at a rate of 2.9%. Furthermore, the average interest rate on these loans decreased against the same period of the previous year.

- **Commercial banking has again been the most important financial intermediary, although its role was down on the previous year**

At the close of June 2013, commercial banking assets represented 48% of the total financial system, while in the same period of the previous year the figure stood at 50%. This decrease is due to slower growth of positions in securities issued by the Mexican Federal Government and declining demand for credit from the private sector, linked to the economic slowdown. In overall terms, these assets stood at 6.3 trillion pesos in September 2013, which represented a real y/y increase of 2.7%. There was also a redistribution of these assets, with lending to the private sector growing from 36% to 39%, and a decline in finance to government agencies via securities and credits.

- **The profitability of commercial banking increased due to windfall profits**

Returns on commercial banking capital (measured as Return on Equity, net profit on stockholder equity) stood at 15.1% at the close of September 2013. This result was driven by: a) windfall profits from the sale of business units by some banks during 1Q13; b) a real annual increase of 60.8% in revenue from securities trading; and c) an improving correlation between administrative expenditure and total income, with a decline of 0.7 pp against September 2012 (68.76% vs 68.06%).

- **The implementation of Basel III standards had no impact on bank capitalization levels, but the new commercial portfolio credit rating methodology did have a negative impact on some institutions**

With respect to banking solvency, the Report highlights a slight decrease in the weighted average of the capitalization ratio (net capital divided by risk-weighted assets), shifting from 16.2% in September 2012 (estimated using Basel II rules) to 16.1% in September 2013 (under Basel III rules). It also points out that the introduction of new capitalization rules for banking had no significant impact on regulatory capital, as most of the Basel III requirements have been included in the Mexico regulatory framework since 2001. However, the introduction of a new methodology to rate the commercial portfolio based on expected losses as of the second semester 2013 had a negative impact on the capital of some banks, due to an increase in preventative estimates for credit risk at these institutions.

[2] Banxico defines exposure as the aggregate of the net credit position from deposits and loans, shareholdings, the net positive valuation of derivatives contracts and the net creditor position of guarantees, repos, stock loans and value date transactions. The total net creditor position for commercial banking stood at 70.4 billion pesos as per September 2013, while the total assets were 6.3 trillion pesos in the same period.

- **The liquidity position of commercial banking declined and its volatility increased, although it remained above the minimum required level.**

On average, the Liquidity Coverage Ratio (LCR) meets the minimum required by the Basel Committee.[3] However, the LCR averages, both for major banks and medium-sized banks, as well as for those associated with commercial chains, show a decline against previous years, an uptick in volatility, and differences between the groups. The decline in the LCR was due to lending growth being mainly financed with market liabilities at maturities of less than 30 days, while the dispersal and volatility were results of variability in the holdings of highly liquid assets.

Banxico considers as an additional source of risk the fact that some banks are issuing long-term securities that are bought by brokerage houses of the same financial group, who place them among their customers via short-term repo transactions. Although this strategy apparently improves banks' liquidity position, under a stress scenario customers of the brokerage houses may decide not to renew the repo operations, which could threaten the bank's ability to continue placing long-term debt. Therefore, Banxico suggests that the liquidity regulations introduced in Mexico should ensure that the relevant maturity be of the repo transaction rather than of the security issued by the bank.

- **The development banking and development funds portfolio continues to grow at rapid rates, although there has been an increase in the past-due portfolio**

The development banking (DB) portfolio has recorded high rates of growth due mainly to the placement of infrastructure credit and top-tier loans to non-financial private-sector companies. At the close of September 2013, top-tier loans recorded an annual real growth of 13.5% as a result of the increase in Bancomext portfolio (17% real y/y) and Banobras portfolio (14% real y/y). Meanwhile, the second-tier portfolio was down 2.7% against September 2012. The main component of the DB portfolio is business lending, which represented 43% of total lending to the private sector. The DB, FIRA and Rural Financial (FR) past-due portfolio recorded a real y/y increase of 36% as per September 2013 and represented 4.5% of the total portfolio. This increase was due to growth of the past-due Nafin and Bancomext mortgage lending portfolio.

Meanwhile, the current Infonavit loan portfolio recorded real y/y growth of 4.0% in June 2013, remaining the leading mortgage lender, with its portfolio representing 58.2% of total mortgage finance in Mexico. However, its past-due portfolio was up substantially, having grown in September 2013 by 15.6% on the same period the previous year.

- **The exposure of banking to other intermediaries is low, meaning the risk of contagion is limited**

According to the report, the assets of intermediaries not subject to traditional banking regulations in accordance with the *Financial Stability Board* (FSB) methodology, represented around 23.4% of GDP as per June 2013 and 22.4% of total assets in the financial system.[4] The risks deriving from these institutions being connected with banks are limited, as banks' exposure to the sector as a whole accounts for just 2.4% of the total banking portfolio.

- **Financial markets in Mexico recorded mixed performances**

The Report divides the period of analysis into two segments. In the first, from September 2012 to early May 2013, there were significant investment flows to emerging countries. In the second, which covers from the second half of May up to September 2013, there were capital outflows from emerging markets due to the expectation that the Federal Reserve would slow its asset purchase program, although recently, contrary to what had been anticipated, the Fed decided to delay its decision. In this climate, the report states that in the early part of the period Mexican exchange rates appreciated, while international reserves continued to grow to levels in excess of 170 billion dollars. In the latter part of the period the exchange-rate trend reversed, although transaction volumes for the peso continued to grow and transaction conditions suffered no deterioration, with none of the volatility seen in the past.

The debt market behaved in a similar way to the exchange rate: early in the period interest rates were down and the yield curve slope declined to levels not seen since 2009, while foreign investor holdings of peso-denominated securities increased. However, during the later part there was growth of more than 100 basis points in long-term government debt rates. Likewise, in the equity market the performance of the IPC index was favorable during the first period, driven by foreign capital inflows. In the second period there was a decline due to capital outflow and a weak performance by construction companies. Despite this, corporate initial public offerings, FIBRAS and CDCs all increased, with six issuers being listed in 2012 compared to ten in 2013. Finally, the performance of the derivatives market reflected the same movements.

[3] According to the Basel Committee methodology, the liquidity coverage ratio is defined as the quotient of high-quality liquid assets as a proportion of the expected net cash outflows (cash outflows minus cash inflows) in a stress scenario.

[4] These institutions are brokerage houses, Sofomes (regulated and non-regulated), investment companies, credit unions, popular savings and loan institutions, institutions or companies offering credit, security issuing vehicles, exchange-traded funds (ETFs), capital development certificates (CDC) and infrastructure and real estate trusts (FIBRAS).

- ## The Report details the main regulatory reforms due to be introduced in Mexico for OTC derivatives and market infrastructure

Following the 2008 global financial crisis, financial authorities identified significant weaknesses in the OTC derivatives market, including insufficient information on transactions and associated risks. As a result, members of the G20 agreed to take action to bolster the OTC derivatives market, such as requiring that these transactions be traded on exchanges or electronic platforms, be cleared through central counterparties (CCP), be reported to trade repositories and that non-centrally cleared derivatives be subject to higher capital requirements.

In Mexico, in line with these new requirements, the SHCP, the CNBV and Banxico are working on a plan to change current regulations, generating various sets of rules: tripartite rules, rules for electronic platforms, capitalization rules and the Banxico Circular on derivatives transactions. Initially these new rules will be introduced for peso-dollar forward transactions and interest-rate swaps, as these instruments record the highest transaction volumes in Mexico. The first reforms to be published will be the Tripartite Rules, under which the company Asigna will act as CCP. There will also be efforts to ensure that this company meets all the necessary requirements to be recognized by European and U.S. authorities, so that foreign institutions may continue operating with these instruments without facing additional capital charges. In the second stage, changes will be introduced to oblige banks and brokerage houses to negotiate contracts via derivatives exchanges and electronic platforms recognized in Mexico and abroad, and for these contracts to be cleared and settled through authorized CCP.

Regulatory changes will also be used to improve the functioning of market infrastructure, following the Principles for Financial Market Infrastructures drawn up by the G-20 and published in April 2012.[5] These principles are made up of 24 standards applicable to infrastructures and five responsibilities for financial authorities. The principles cover aspects such as general organization, credit and liquidity risk management, transaction settlement, custody and exchange of securities, general business and operational risk management, access and participation requirements, efficiency and transparency. The authorities' responsibilities require that the infrastructure be subject to appropriate regulation, supervision and oversight, as well as for these authorities to have sufficient powers and resources to perform these tasks.

- ## Banxico is also preparing regulation on electronic payment channels to improve competition

The Report indicates that Banxico is already driving regulatory changes to promote interbank mobile payment services, in order to improve competition between the schemes currently in operation.

With respect to credit card transactions, Banxico highlights the growth in this payment channel over the last three years, with an average rate of 21% and 1,450 million payments in 2012. Part of this growth is due to a drop in interbank service charges for credit cards, driven by Banxico. In the January to June 2013 period, the average weighted service charge by credit card issuers for commercial banks (acquirer banks) was 1.42% of each payment amount. The average interbank service charges for debit cards stood at 0.69% of each payment amount. Meanwhile, the "discount rate" (the fee that acquirer banks charge businesses for receiving card payments) amounted to 2.22% of the total credit card transaction amount and 1.62% for debit cards.

Despite declines in these service charges, Banxico recognizes that there are fewer POS devices and card payments at retailers than in other countries. For example, in Brazil as per December 2011 a total of 29 card payments were made per capita, while in the U.S. the figure is 235. In Mexico the figure was 13 payments in 2012. To promote card use, the Report announces that Banxico will issue provisions to improve innovation and development in the sector, by supporting the emergence of more specialized payment processing companies that offer services to acquirer and issuer banks.

In line with this new regulatory framework, Banxico recently issued a new set of rules designed to improve the efficiency of the transfer network via mobile devices and promote competition in the market. These rules include: 1) allow banks to link deposit accounts with the account holder's mobile device at their request, making transfers easier; 2) extend SPEI operating hours, speed up transfer processing via mobile devices and bring down the fees charged by Banxico on banks for using the service; 3) establish limits on the fees charged by banks to their customers for making transfers via mobile devices, and 4) establish requirements under which Banxico will grant authorization to companies that wish to organize and operate as clearing houses.

[5] The infrastructure of the Mexican financial system is made up of the interbank electronic payment system Sistema de Pagos Electrónicos Interbancarios (SPEI), a securities settlement system Depósito, Administración y Liquidación (DALI), the central clearing house Contraparte Central de Valores (CCV), the clearing and settlement institution Asigna Compensación y Liquidación (Asigna) and the Bank of Mexico's account-holder support system Sistema de Atención a Cuentahabientes (SIAC).

- **According to stress-test results, the most severe losses for the system would come under higher credit risk scenarios**

The results of the stress tests performed by Banxico indicate that the most severe losses to the system would come under the highest credit risk scenarios, in which economic activity contracts significantly. This impact is mainly due to the persistence of initial shocks rather than their severity. In the scenarios of greatest market risk, results indicate that the system would maintain capitalization rates above minimum requirements even in the most severe scenarios.

- **In its overall risk assessment, Banxico highlights the risks associated with monetary-policy decisions, the performance of the U.S. economy and a further slowdown by the Mexican economy**

Banxico recognizes that the risks related to global economic activity have not waned, in particular those linked to the performance of the U.S. economy. The reactions from the financial markets to the U.S. economic performance and monetary policy announcements may vary in intensity and duration, with some adverse effects on the Mexican financial system. For example, in the event of a weak recovery by the U.S. economy combined with an uptick in interest rates from the Federal Reserve or economic stagnation in emerging markets, along with more pronounced capital outflows, financial intermediaries and investors may see their assets decline in value, while debtors may find it harder to make debt repayments and credit quality would decline. However, if the U.S. economy recovers and the Federal Reserve lifts interest rates we can expect a period of tension, but this should dissipate as the country's economic recovery is consolidated.

If the slowdown in economic activity seen in Mexico over the first half of the year becomes more serious, this could have a negative effect on banks' loan portfolios, by driving up default rates. However, Banxico still expects public expenditure levels to return to normal, and initial positive effects from the structural reforms that have already been approved or whose approval is imminent, thus helping economic growth in Mexico to recover.

Appraisal:

While the Bank of Mexico recognizes the solvency of the Mexican financial system, it has also identified external risks, particularly those linked to monetary policies in the U.S. and the future performance of the Mexican economy. Furthermore, Banxico emphasizes the importance of financial reforms (recently approved by the Senate and submitted to the executive for enactment) to bolster the financial system and improve its ability to weather significant capital flow fluctuations. In this regard, we concur with Banxico's opinion that Mexico has solid macrofinancial fundamentals. We believe that as the Mexican economic recovery gains traction household income will grow and there will be increasing investment opportunities for companies, with both credit and financial savings able to grow faster. However, we will have to wait for the announcement of secondary regulation derived from the financial reforms before we can make a fuller assessment of what impact there will be on financial intermediaries and credit and savings flows.

As for future rule changes for OTC derivatives, payment systems and market infrastructure, we expect favorable effects in terms of efficiency and the reduction of systemic risk by supporting transactions and making them more transparent. However, a more precise estimate of their impact will still have to await the announcement of various regulatory projects. Based on available information, we believe that the package of Banxico measures announced some days ago for payment channels could support the use of mobile devices and buoy financial inclusion, as well as driving competition to ensure more efficient use of these channels. However, some of the rules, including changes to the SPEI operating hours to allow a wider time window for transfers, may cause banks to shoulder greater operating costs.

Finally, regarding the classification of financial institutions proposed by the FSB and adopted by Banxico, one key aspect is the grouping of very diverse institutions under the category of institutions not subject to traditional banking regulations (such as brokerage houses and popular savings and loan institutions, for example). We believe it is important to take into account the characteristics of each kind of institution, as well as the level of regulation and supervision that they are subject to. This would help quantify the risk that each represents for the financial system as a whole.

Carlos Serrano
carlos.serranoh@bbva.com

Sirenia Vázquez
sirenia.vazquez@bbva.com

Saidé A. Salazar
saidearanzazu.salazar@bbva.com

BBVA RESEARCH
Avenida Universidad 1200, Colonia Xoco, México DF, CP 03339 | www.bbvaresearch.com