Banks

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

Business loans have become more sluggish, while consumer loans deepen their slowdown

In April 2019, the annual nominal growth rate in the balance of the current credit portfolio granted by commercial banks to the non-financial private sector was 10.3% (5.6% in real terms). This growth rate was lower than in the previous month (11.1%) and also lower than that in the same month of 2018 (11.5%). It should be noted that the lending growth rate in April 2019 (10.3%) is similar to the 10.4% average rate registered in the first quarter of the year. The annual nominal growth rate in April 2019 for the three current credit components granted by commercial banks to the private sector was as follows: 5.9% for consumer loans; 10.3% for mortgage loans; and 12.1% for business loans. The percentage structure of the outstanding balance of bank credit to the non-financial private sector in April 2019 was as follows: 58.4% for business loans; 22.8% for consumer loans; and 18.8% for mortgage loans. In that month, the contribution to the growth of these three items to the growth of total credit to the non-financial private sector was as follows: companies contributed 7 percentage points (pp) of the total of 10.3 pp in credit growth; mortgages, 1.9 pp, and consumers, 1.4 pp.

Several factors underlie the observed growth of bank credit granted to the non-financial private sector. One element that has favored the performance of business loans has been the process of substituting foreign financing sources with domestic bank credit; however, this factor has lost momentum and there was less growth recorded in credit granted to larger companies. The moderate growth rate in household finance is due to the slower rate of increase in new formal employment, as reported by statistics from the Mexican Social Security Institute (IMSS). This slower rate of expansion of formal IMSS employment has been accompanied by the recovery and increase in the average real wage of these workers. In other words, the positive growth of formal employment, albeit at a slower pace, together with the increase in real wages, have sustained the positive growth of household financing.

Traditional bank deposits picked up in April, boosted by term deposits

The combination of weak economic activity and high short-term interest rates is keeping down the growth of demand deposits, which are the main component of traditional deposits. Although high interests in recent months have given rise to greater dynamism of term deposits, this did not offset the fall in the segment of sight deposits. This reflected a lower growth in traditional deposits compared to the previous year. In effect, in April 2019 the nominal annual growth of traditional deposits in commercial banks (sight + term) was 8.1%, which is slightly higher than in the previous month (7.8%), and lower than in the same month of 2018 (9.0%). The greater dynamism of the term component in April

(14.5%) over the sight component (4.0%) was repeated for the tenth consecutive month and is reflected in the composition of the growth and in the relative weight of the two segments in traditional deposits. Sight deposits went from representing 61.4% of traditional fund-raising in April 2018 to 59.0% in April 2019, while term deposits went from 38.6% to 41.0% in the same period. With regard to the contribution to the growth rate of traditional deposits, in the last ten months term deposits have contributed an average of 5.9 percentage points (pp) to the 8.9 pp average growth rate of traditional deposits, virtually double the sight component (which contributed an average of 3.0 pp).

With regard to other savings and investment alternatives, it is worth noting that the increase in interest rates has not favored deposits that are channeled toward shares in Debt Investment Funds (FIDs), which in April 2019 showed a nominal annual growth rate of 2.8% (real rate of -1.6%). As long as bank and benchmark interest rates remain at high levels or do not fall, savers are unlikely to stop channeling more of their financial resources toward term bank deposits, as these instruments continue to offer relatively higher yields.

Mortgage lending increased, with higher average amounts and a slight increase in the interest rate

Bank of Mexico published its Report on Basic Mortgage Loan Indicators with data as of September 2018 (Sept-18). This report compares prices and other supply conditions of mortgage loans granted by regulated financial intermediaries, and its purpose is to foster competition in this market. Banxico presents data on total loans granted and also on those it considers to be comparable between financial institutions. In addition, the report considers loans granted in local currency and at a fixed rate. The purpose of the loans is: i) home acquisition; ii) self-construction; iii) remodeling or improvement of individual home; iv) liquidity; v) payment of mortgage debts.

From Oct-17 to Sept-18 banks directly granted 105,385 mortgage loans in their different forms (15.7% higher than loans granted in the period Oct-16-Sep-17). The interest rate and weighted average term for the balance of these loans was 10.3% (vs. 10.0% the previous year) and 18 years (equal to the Oct-16-Sep-17 period), respectively, and the average loan origination amount was just over 1.4 million pesos (vs. 1.3 million pesos the previous year).

The report also indicates that in the same period banks granted 41,516 loans in partnership with national housing agencies (ONAVIS) to acquire housing, a number significantly higher than the 15,269 granted in the period Oct-16 to Sep-17. The amount, rate and average term were 569,000 pesos; 10.9%; and 21 years (vs. 303,000 pesos, 10.5% and 20 years the previous year).

With respect to the portfolio of comparable mortgage loans between institutions, the Report indicates that from Oct-17 to Sept-18, 84,876 loans were granted. 48.9% of these were with a down payment of 20% or greater (loan to value less than or equal to 80%); and the remaining 51.1% had a down payment of 20% or less. In that period the weighted average interest rate for all loans was 10.2%. For those which had a 20% or higher down payment the rate was 10.2%; and for loans with a down payment of less than 20% the average rate was 10.3%. 44.4% of the 84,876 comparable loans granted from Oct-17 to Sept-18 were channeled to medium housing; 38.5% to residential housing; and 17.2% to social housing. In addition, the average loan origination amount was 3.8% higher in real terms than in the same period of the previous year.

It should be noted that the Banxico Report from Oct-16 to Sept-17 indicates that 74.3% of comparable loans had a down payment of 20% or less and in the remaining 25.7% the down payment was greater than 20%. During this period the average interest rate was 9.9% for the total portfolio; 9.8% for down payment loans of 20% or more; and 10.3% for down payment loans of less than 20%. Additionally, the comparison of figures from Oct-17 to Sept-18 with those from Oct-16 to Sept-17 of the comparable loan portfolio between institutions indicates that in the first period in relation to the second, the percentage of mortgage loans granted whose down payment was equal to or greater than 20% decreased; the average interest rate on these loans increased; and the average amount of credit granted also increased by 3.8% in real terms.

The trend in these figures indicates that those who took out a housing loan in the period Oct-17 to Sept-18 were willing to pay higher rates and loan amounts in real terms while paying lower down payments per loan acquired. This may be due to the high value for them of having a home or their expectations that in the future they will not have access to a home given that the value of the property continues to rise and the conditions of access to these loans would be more restrictive, and they would be unable to meet them.

In 2018, payroll loans slowed their growth rate

Banxico published its Report on Basic Payroll Loan Indicators with information from January to December 2018. The purpose of this report is to allow for a comparison of the conditions under which payroll loans were offered during the period in question, with the aim of stimulating competition in this market. The central bank only includes comparable loans in its analysis. That is, it excludes loans that have preferential conditions or whose initial conditions of contracting were modified due to delays, default or restructuring of the debtors' loans.

Throughout 2018, institutions granted 2.45 million payroll loans, 1.7% lower than the 2.49 million loans granted in 2017. In 2018, 53.3% of the loans granted (53.6% in 2017) were for an original amount of up to 40,000 pesos and the remaining 46.7% (46.4% in 2017) were for larger amounts. In 2018, the median interest rate charged by these loans was 24% for the total (the same rate in 2017); 25% for loans up to 40,000 pesos (the same rate in 2017); and 24.0% for loans over 40,000 pesos (vs. 23.5% in 2017).

In addition, in 2018 the average balance of total loans granted was 69,599 pesos (3.7% higher than in 2017 in real terms), while for loans in the range of up to 40,000 pesos it was 17,909 pesos (-4.7% lower than in 2017 in real terms) and in the range of more than 40,000 pesos stood at 128,571 pesos (higher than 4.6% in real terms).

It should be noted that, in addition to the fact that the number of payroll loans granted in 2018 (2.45 million) was lower than those granted in 2017 (2.49 million), both figures are lower than the payroll loans granted in 2015 and 2016 (2.56 million and 2.60 million). These results signal a gradual slowdown in the number of payroll loans. This could be associated with the slower rate of growth recorded in formal employment by the Mexican Social Security Institute (IMSS), since the workers registered with the Institute are potential customers for this type of credit. For example, in 2017 the average annual growth rate of IMSS employment was 4.4%; and in 2018 it decreased to 4.1%. Thus, it is to be expected that as long as growth in formal IMSS employment slows, as has been the case since the second half of 2018, payroll loans will have no driving factor.

The Financial System Stability Council (CESF) updates its risk balance

On June 19, the CESF published the update of its risk balance. Among the external risks, it identifies the following: 1) the downward revision of the global growth outlook for 2019 and 2020 and 2) the decrease in global risk appetite that could cause both new episodes of volatility in financial markets and portfolio reversal in emerging economies. Further, the statement notes that the Federal Reserve's stance reduces risks associated with tighter financial conditions. In terms of internal risks, it highlights: 1) The tension in the trade relationship between the US and Mexico, 2) the revisions to the ratings for sovereign debt and Petróleos Mexicanos (Pemex), and 3) investment weakness.

As for the banking system, stress tests indicate that the system's levels of capital and liquidity are adequate to deal with severe shocks. This time, the CESF also analyzed the risks associated with non-bank financial intermediation and concluded that, while such activities do not currently pose a risk to the stability of the financial system, their performance should continue to be monitored. It therefore decided to review annually the scope of regulation applicable to these intermediaries.

High concentration of demand for bank mortgage loans

As households take out mortgage loans where they seek to purchase their homes, the regional distribution of these loans reflects their location preferences. In a state-vs-state comparison, it is found that only six of the 32 entities account for just over 50% of the number and amount of financing in 2018. These are: Mexico City, Nuevo León, Jalisco, State of México, Querétaro and Guanajuato. Particularly, in this last year, the last two states in the Bajío, namely, have gained positions in these preferences. Within these states, household preferences focus on municipalities in metropolitan areas, with the exception of Guanajuato, which has a less concentrated distribution. During 2018, the six municipalities in the country that captured the most mortgages for home acquisition are all urban and characterized by high economic activity. Five of the six are state capitals, again with the exception of León, which is not the capital of Guanajuato.

Mexico City and Nuevo León account for more than 60% of the total bank mortgage portfolio. As well as a greater number of loans, this is also because these regions are those with the highest-valued housing and therefore also the highest average mortgage. Although a significant difference between the two states is that Mexico City has practically no social housing to offer, focusing on middle-income and residential housing; while Nuevo León has a more diversified supply, in which the social housing segment is still a significant market.

In terms of non-performing loans, none of the country's states has a rate greater than 4%. Morelos has the largest proportion of past-due portfolio, but this stands at only 3.8%; while Nayarit has the lowest with only 1%. From 2010 to date, the highest level of portfolio impairment was specifically Q1 2010 in Durango, at a level of 7.3%, but this is currently 2.3%.

For further information, please see our publication "Mexico Real Estate Outlook" for the first half of 2019.

2. Financial Markets

Lower interest rate expectation fuels risk appetite

In June, market participants increased their demand for risky assets influenced by the expectation that the looser monetary stance of the world's major central banks will maintain economic expansion, even in an environment with signs of slowdown exacerbated by protectionist risks. In the case of domestic asset prices, there was a temporary deterioration at the beginning of the month due to the threat of US tariffs.

Stock markets are showing gains in this environment, given their high sensitivity to short-term interest rate expectations. Given Fed's more accommodating tone, the S&P 500 posted gains of 6.3% in June, above those seen in the global equity benchmark (5.9%) and the emerging markets benchmark (5.7%). The IPC saw significantly lower growth (1.3%), influenced by the idiosyncratic risks mentioned above.

In the foreign exchange market, the Mexican peso gained 2.0% in June from levels above the exchange rate of $19.60 pesos per dollar at the end of May, when the threat of tariffs became known. The peso has been strengthened by the generalized weakness of the dollar owing to the expectation of lower interest rates in the US for the second half of the year. In fact, its gains in June were slightly lower than the gains of emerging market currencies in aggregate (2.2%).

In the US bond market, expectations of lower rates in the short end and gloomy global growth prospects have brought 10-year government yields even below 2.0% for the first time since 2016. Meanwhile, the two-year node is trading below 1.75%, its lowest level since late 2017. In Mexico, the government yield curve is also falling, even after the cut in the sovereign debt rating, which, to a large extent, was already discounted by markets. Thus, the 10-year M bond is trading below 7.6% (-40 basis points in June), influenced by the high correlation with US Treasury yields and expectations of short term rate cuts in Mexico.

Relatively high yields on Mexican debt have led foreign investors to maintain their level of exposure to the long end of the government curve. During May and the first half of June, foreign holdings of M bonds grew by around USD 1.8 billion. Thus, the year-to-date figure in 2019 is around USD 4 billion, a figure similar to that observed in the first six months of 2016, 2017 and 2018. At the short end of the curve, the closure of arbitrage opportunities has fed into a continuous fall in holdings of CETES by foreigners, which accounted for 24% of the total in circulation in of the first half of June.

In the long-term corporate debt market, the amount issued recovered significantly in June. With data as of the 21st, the cumulative amount for 2019 is above MXN 113 billion, a figure that exceeds that issued during the first half of 2017 and represents a significant increase over the MXN 15 billion in the year to date through the month of April. It should be noted that about 42% of the accumulated amount in 2019 corresponds to bank issuers.

Lastly, it is important to note that one agency's downgrading of the sovereign debt rating did not generate significant effects, as this movement was already largely discounted by market participants. In fact, in the Credit Default Swaps market for several months now, Mexican debt has been trading with a spread similar to that of countries with a BBB- rating, up to two notches below Mexico's rating with some agencies. The downgrading in the PEMEX rating did generate adverse effects, but these were generally confined to the oil company's own assets. In fact, the difference between the yield to maturity of the 10-year PEMEX bond and the sovereign in dollars increased from 260 bp at the end of May to around 330 bp at the end of June, after the rise of just over 30 bp in the oil company's bond yield and a fall of around 40 bp in the sovereign bond yield.

3. Regulation

OTC Derivatives

Bank of Mexico submitted to public consultation a draft project to determine initial and variation margins for derivative transactions outside clearing houses (OTC derivatives). Among others, it establishes a standard methodology for its calculation, as well as the requirements for the development of internal methodologies.

Repo and securities lending

Bank of Mexico submitted to public consultation draft projects to make repurchase agreements and securities lending transactions more flexible. Among other aspects, both projects broaden the type of entities that can carry out such transactions, as well as the credit quality of eligible debt securities.