Banking

Monthly Report on Banking and the Financial System

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1. Banking and the Financial System

In January, bank credit to the non-financial private sector saw its ninth consecutive month of nominal single-digit growth

In January 2020, the annual nominal growth rate in the balance of the current loan portfolio granted by commercial banks to the non-financial private sector (NFPS) was 5.3% (2.0% in real terms). This nominal annual growth was slightly higher than that of the previous month (5.1%), but significantly below that recorded in the same month of 2019 (10.0%). It should be noted that, while NFPS credit slowed significantly throughout 2019, its annual nominal growth left double-digits in April that year. Also, January 2020 marked nine months in a row of single-digit growth. In addition, in October 2019, its nominal annual growth began to show another significant sign of slowdown — growth between October 2019 and January 2020 was less than 6% for four months straight.

Additionally, in January 2020, the nominal annual growth rate of each of the three credit categories that make up the bank credit to the NFPS was as follows: Consumer, 4.9% (5.3%, in the previous month); Mortgage, 10.4% (10.7%, in the previous month); and Business, 3.8% (3.1% in the previous month). Meanwhile, the contribution of its components to the growth of bank credit to the NFPS in January 2020 was as follows: business loans accounted for 2.2 percentage points (pp) of the 5.3 pp growth in credit to the NFPS that month. The contributions to mortgage and consumer loans were 2.0 pp and 1.1 pp, respectively.

The behavior of GDP, Gross Fixed Investment and business confidence during 2019 and early 2020 indicates that the macroeconomic environment at that time was not conducive to higher rates of bank credit to businesses. In addition, the deterioration of economic activity and the slowdown in formal IMSS employment explain the lower dynamism in consumer loans. Only mortgage loans managed to maintain a double-digit nominal growth rate in January, although the rate slowed for a second consecutive month.

Bank deposits show sensitivity to the risks of the economic environment

During the month of January, bank deposits remained weak as a result of stagnation in economic activity and lower short-term interest rates. The decline in investment in 2019 and the consensus among analysts that economic activity will improve only marginally in 2020 have led companies to reduce their deposits in the banking system over the past year. In the case of individuals, sight deposits have been favored by the substitution effect from term deposits, but economic weakness has slowed the growth of this segment.

As such, nominal annual growth of traditional deposits (sight + term) in January was 5.5% (2.2% in real terms), which is slower than the nominal 6.9% (3.2% in real terms) average annual growth that was recorded in 2019. Growth in

January was supported by the annual growth of 6.3% (3.0% in real terms) in sight deposits and a weak nominal annual growth of 4.4% (1.1% real) in term deposits.

The outlook for bank deposits in the coming months presents significant challenges. Firstly, formal employment data for February shows a continuing loss of dynamism in formal job creation, which will eventually weaken sight deposits—the most dynamic segment in recent months. Secondly, within a context of lower interest rates, term deposits have a limited growth margin. Finally, the economic impact of a possible spike in coronavirus cases in the country is likely to be reflected in an adverse effect on deposits in the medium-term, even though there may be some growth in the short-term.

The credit granted by banks remained the main source of funding for the private sector

The National Banking and Securities Commission (CNBV) published the statistics on Financial Savings and Financing in Mexico with figures to September 2019 (Sep–19). In that month, financial savings represented 97.4% of GDP, with real annual variation of 3.9%. For its part, total lending (domestic and external) to both the public sector and the private sector was equivalent to 97.9% of GDP and recorded a real growth of 2.6% compared to the same month of the previous year.

In terms of financial savings, domestic savings (71.1% of the total) are of particular note— with real growth of 5.2% at an annual rate. It should be noted that deposits by financial intermediaries (banks, savings and credit cooperatives, credit unions, and development agencies and bodies) account for about half of the domestic savings balance and had seen growth of 1.8% of GDP as of Sep–19. The other component of domestic savings is the holding of fixed income securities and trust stock certificates, the balance of which increased at a real annual rate of 8.7% in the aforementioned month. Meanwhile, at the end of the third quarter of 2019 (3Q19), external savings (28.9% of the total) saw annual real growth of 0.8%. In this case, the external savings by the public sector represented 18.8% of GDP (with real annual growth of 0.8%) while external savings by the private sector was equivalent to 9.3% (showing real annual growth of 0.9%).

It is worth noting that, in 3Q19, domestic lending to the private sector represented 38.2% of GDP, and the lending granted by the banking industry (48% of domestic lending to the private sector) remained the main source of funding for the private sector. In the case of domestic lending to the public sector (41.1% of GDP), the main source of funding was the issuance of securities, which represented 92% of lending to that sector. In turn, the balance of external lending to the private sector reached 8.8% of GDP in 3Q19, while external lending to the public sector amounted to 9.6% of GDP in the aforementioned period.

Financial intermediaries have granted one third of the formal loan portfolio to mortgage loans over the past five years

In March 2020, Banco de México (Banxico) published its Report on the competitive environment in the mortgage lending market (Report). The study aims to analyze the competitive environment in the mortgage lending market for the purchase of a new or existing residential property, which is mortgaged to guarantee the recovery of the loan. The analysis includes both credit provided by the national housing agencies (ONAVI) and that provided by financial institutions (FI).

According to the Report, over the past five years, two-thirds of the loan portfolio originated from ONAVI and the remaining third was from FIs. The degree of substitution between loans from ONAVI and loans from FI is small, although, in some cases, these loans may be complementary. In particular, commercial banking is the main private financial intermediary in the mortgage lending market. More than 90% of the lending is provided by six banks and the Herfindahl-Hirschman Index (HHI) has been around 2000 points for the past five years. In this context, the individual share of each bank is quite similar. This is consistent with an environment in which the incentive for customers to compare banks and for banks to compete for customers is greater in the case of mortgage loans than in other types of loans. In addition, rivalry and mobility rates are higher compared to other types of loans, while risk-adjusted margin and profitability before administrative expenses are lower than in other types of lending and have fallen.

The Report identifies some areas of opportunity to improve the conditions under which end users access mortgage loans. The first is to establish open access to the resources in the housing sub-account, which would allow workers who have this sub-account with an ONAVI to choose the loan provider that they prefer. In addition, sharing the infrastructure for credit origination would help to bring down search costs for the worker. Another proposal concerns the opening of the credit collection infrastructure developed by the ONAVI, so that they can offer a regular loan collection service to the FIs. In the case of FIs, the areas of opportunity detected included reviewing the creditor subrogation scheme and encouraging the development of cost comparison platforms and access to loan offers, among others.

Portfolio balances mirror patterns of economic activity at the end of 2019

The Regional Economic Report by Banco de México[1] points out that the current portfolio of non-financial private companies in commercial banking recorded a real annual increase of 0.9% in 4Q19, in line with the contraction of production activities at the end of 2019. The low growth is the result of a contraction in the North and Central regions by 0.2% and 1.6%, respectively, as well as a slowdown in the North Central and South regions, which grew by 9.7% and 8.7%, respectively.

The current portfolio of agricultural activities grew in all regions in 4Q19. The North Central region is particular noteworthy, with growth of 11.0%, followed by the South, with 7.0%, the North, with 6.4% and the Central, with an increase of 4.5%. With respect to industrial activities, the current portfolio presented an outstanding growth rate in the South, with a real annual variation of 19.7% and a more modest one in the North Central region, with 4.8%, while the North and Central regions showed contractions of 2.7% and 4.0%, respectively. Tertiary activities also showed an increase in portfolio balances in all regions. In terms of real growth, the largest increase was in the North Central region, with 12.8% real growth, followed by the South, with 3.2%. With lower credit activity, services in the North region grew 1.5%, while the increase in the Central region was just 0.2%.

1: The regional classification referred to in the report corresponds to the following groups: the North region includes Baja California, Chihuahua, Coahuila, Nuevo León, Sonora and Tamaulipas; the North Central region includes Aguascalientes, Baja California Sur, Colima, Durango, Jalisco, Michoacán, Nayarit, San Luis Potosí, Sinaloa and Zacatecas; The Central region is made up of Mexico City, Mexico State, Guanajuato, Hidalgo, Morelos, Puebla, Querétaro and Tlaxcala; and the South is made up of Campeche, Chiapas, Guerrero, Oaxaca, Quintana Roo, Tabasco, Veracruz and Yucatán.

The dynamics of credit balances presented in the report are consistent with the growth in sectoral GDP observed at the end of 2019, with an increase in primary activities, an industrial contraction and a very modest performance of tertiary activities, as can be found in more detail in the Mexico Regional Sectoral Outlook report for the first half of 2020.

2. Financial Markets

The coronavirus pandemic is generating losses in financial markets of a magnitude not seen since 2008

The speed of the plummet in prices of risk assets in March was enough for the first quarter of 2020 to be one of the worst for several types of assets since the 2008 financial crisis. The rapid spread of coronavirus throughout Europe and the US intensified fears about the intensity and duration of the pandemic, as well as its effects on global economic activity. These fears exacerbated uncertainty among players in the financial markets, resulting in the mass sale of risk assets, which in turn led to liquidity problems in the US Treasury bond and dollar markets—both of which are considered risk-free assets. In this context, the world's major central banks relaxed their monetary policy and injected liquidity into the market, but, as expected, it was not until the US Congress passed a $2 trillion economic support package that the price of risk assets stopped falling.

In the stock markets, March's losses were at double-digit levels, meaning that the most significant markets ended the quarter in a bear market situation. At the regional level, the biggest declines during the third month of the year were in emerging markets (15.6% [MSCI EM]) and Europe (14.8% [Euro Stoxxx 600]), which were above the global benchmark drop (13.5%, [MSCI World]). Meanwhile, the S&P 500 fell by 12.5% in March, meaning a fall of 20.0% in the first quarter. The IPC fell by 16.4% in March, bringing the quarter to a close with a 21.0% drop in local currency. It should be noted that, following the approval of the US tax support package on March 24, the major stock indices recorded a significant recovery. In the case of the S&P 500, this amounted to 15.5% between March 23 and 31.

As mentioned earlier, the sale of risk assets resulted in strong demand for US Treasury Bonds, to the point that liquidity shortages were generated. In fact, for several days, there was strong risk aversion, significant declines in stock indices and increases in Treasury Bond yields. This was despite the fact that the Fed had already reduced the federal funds rate to a level of between 0 and 0.25% on March 15. The various measures taken by the Fed to inject liquidity stabilized fixed income markets; thus the yields on US debt continued their downward trend. As such, the yield to maturity on the 10-year bond fell by 48 basis points in March, standing at 0.67% at the end of the month, after registering a historical low of 0.54% on March 9.

The increase in risk aversion (the VIX reached a new historical peak of 82.7%) led to high demand for dollars, which resulted in a widespread appreciation of the US currency. This appreciation during the month of March amounted to 0.9% compared to developed country currencies and 8.3% compared to emerging countries. It should be noted that, within the latter group, several currencies were affected by the sudden fall in the price of oil, following the decision of Saudi Arabia and Russia to increase their production in this low-demand environment. The Mexican peso was one of these currencies, seeing depreciation of 20.5% in March, with the exchange rate closing the month at 23.7 pesos for dollar. This significant depreciation of the national currency appears to price in expectations of a fall in economic activity and a deterioration on the fiscal front, but it has also been affected by clear signs of lack of liquidity. In fact, the difference between the purchase and sale price in the dollar market (bid-ask spread) in March was even higher than the levels observed after Lehman Brothers filed for bankruptcy in September 2008.

The high correlation between the daily exchange rate movements and oil prices (correlation coefficient of 0.8% in mid-March) followed a fall in energy prices of over 50% during the third month of the year. In fact, the price of the Mexican oil mix plummeted by 72% in March, closing the quarter at $10.76 per barrel, slightly above the $10.37 of March 30, which is its lowest level since the 1990s.

In the context of a weak economy, with growing uncertainty about economic policy, prospects of a sharp decline in GDP this year and the expectation of low oil prices combined with PEMEX's weak financial situation, the fiscal risks for Mexico mounted. All of this made one of the main global credit rating agencies cut Mexico's long-term default rating in foreign currency from BBB+ to BBB. This movement leaves our country just one step above the minimum level to be considered as investment grade. This announcement was already, to some extent, incorporated into the USD debt market and in the sovereign risk market since our country has been trading at levels close to those of BBB- rated countries, such as Colombia and Russia, for several months now.

As mentioned in the February report, fiscal and monetary stimuli would be just one of the elements needed to think that prices of risk assets could be reaching the bottom. This first element has already materialized and managed to bring stability to markets in the last days of March. The other element is associated with clear signs of containing the coronavirus pandemic in order to be able to estimate the economic costs associated to lockdown measures in a less uncertain manner. For now, we are far from witnessing the accomplishment of this second element as the speed of contagion in the US and other regions rises. Consequently, it seems premature to claim that the downward trend in the prices of risk assets is behind us and that volatility will show a downward behavior from this point on.

3. Regulation

Response to the COVID-19 Contingency

Credit institutions offered their clients support programs , which include the deferment of capital and interest for four and up to six months. For its part, the CNBV issued special accounting standards so that the loans supported in this way are not considered overdue or restructured. This facilitates bank's efforts to benefit their clients and will prevent them from receiving negative entries on their records with credit reporting companies.

In the same vein, on March 20, Banco de México issued a statement announcing a series of measures to provide liquidity to the financial system. This will facilitate their operation in light of the increasing level of stress caused by the contingency. These measures include the relaxation of the Monetary Regulation Deposits that institutions hold with the central bank, a reduction in the interest rate on its Additional Ordinary Liquidity Facility, US dollar credit auctions and collaboration with the SHCP (*Secretaría de Hacienda y Crédito Público* — Ministry of Finance and Public Credit) to strengthen the Public Debt Market Maker Program.

Bank accounts for individuals over the age of fifteen

On March 27, the Credit Institutions Act was modifiied to allow individuals over the age of 15 to be able to sign money deposit contracts, as well as to have funds deposited without the involvement of representatives (as will continue to be necessary for those under 15 years of age).

The reform establishes that Banco de México will determine the level of transactionality, limitations, requirements, terms and conditions of the said accounts; which, in any case, will be exclusively limited to electronic deposits, from government programs or, where appropriate, from wages or salaries deposited by their employer. The receipt of cash deposits or electronic transfers by natural or moral persons other than those indicated is prohibited. Likewise, it will not be possible to take out loans against the funds deposited in these accounts.