



BANCO DE MÉXICO®

Financial Stability Report

Executive summary

June 2022

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The Mexican financial system maintains a solid and resilient position. In particular, commercial banks have capital and liquidity levels that amply exceed regulatory minima. Nevertheless, the system faces important challenges posed by the remaining effects of the COVID-19 pandemic and the new challenges stemming from the geopolitical conflict between Russia and Ukraine, on the one hand, and persistent global inflationary pressures, on the other. The latter have led to the withdrawal of monetary stimulus in several economies and, in general, to tighter global financial conditions.

During the first half of 2022, world economic activity registered a sharper-than-expected deceleration, and the IMF's growth estimates for the world economy have been revised significantly downwards for 2022 and, to a lesser extent, for 2023. This was a result of persistent bottlenecks in global supply chains, the continued negative effects of COVID-19, and increasing geopolitical tensions caused by the military conflict between Russia and Ukraine. In this context, global inflation continued increasing, particularly energy and food prices.

Thus, in such an environment of lower expected economic growth, greater uncertainty regarding the evolution of global financial conditions, and geopolitical tensions, monitoring the evolution of the financial system and maintaining its stability will be of utmost importance. Additionally, lending in Mexico has yet to register the robust and generalized recovery required to support and boost economic growth.

Domestic financial markets have also been affected by the above-described environment, with mixed performance and some volatility. The Mexican peso depreciated against the US dollar between late February and early March 2022. However, since then, it has strengthened. Meanwhile, the yield curve increased across all terms. All aggregate risk indicators exhibited some upward adjustments. The Mexican Financial Markets Stress Index (*IFMF*, for its acronym in Spanish) increased slightly, and is above its pre-pandemic level, although below its average during 2020, showing mixed dynamics throughout the period analyzed in this Report. Meanwhile, the

domestic Financial Conditions Index (*ICF*, for its acronym in Spanish) has been slightly tighter since December 2021. Uncertainty regarding the future evolution of financial markets persists, and the possibility of new episodes that could generate a further deterioration of financial conditions cannot be ruled out. In such a situation, capital flows to emerging market economies, including Mexico, could be affected and firms' financing costs could increase.

Certain vulnerabilities and risks for the financial system that increased with the pandemic have been declining. Nevertheless, challenges posed by the current economic environment persist. Economic policy uncertainty has been increasing globally, mainly after the military conflict between Russia and Ukraine began. Furthermore, although the Mexican financial system's direct exposure to this conflict is limited, the international prices of certain commodities have risen, which could reduce the profitability of certain economic sectors that use them as inputs, reducing firms' ability to meet their credit obligations.

Total financing in the economy has displayed a slow recovery and, as a fraction of GDP, it is practically at the same level as that during the second quarter of 2017. The financing gap, the difference between trend credit growth and current period credit growth, continues to decline, and has recorded four quarters with negative figures, reaching levels similar to those observed at the end of 2006.

Total financing to households from all sources fell marginally in real annual terms during the first quarter of 2022. Nevertheless, consumer credit granted by commercial banks and their subsidiary *sofomes* somewhat recovered, registering positive figures for the first time since the onset of the pandemic in practically all its segments, except for auto loans. At the end of the first quarter of 2022, total mortgage loans were slightly higher relative to the same period of the previous year, but growth has been at a slower pace since the last *Report*. Total financing to non-financial private firms in Mexico continues to decline in real annual terms both domestic and external components. During the first quarter of 2022, issuance of new loans to larger firms stabilized as the pace of contraction slowed, thus

resulting in a milder deterioration of credit to these firms compared to that of smaller firms.

Regarding the public sector financial position, at the end of 2021, it registered a deficit equal to that planned in the 2021 Economic Package. The Public Sector Financial Requirements recorded a deficit equivalent to 3.8% of GDP. As for state-owned enterprises, Pemex's financial position has improved slightly in recent months. This improvement resulted from increases in its revenues and operating cash flow following the rise in oil prices, as well as higher export volumes. The company's credit ratings from the rating agencies remain unchanged.

Regarding external financial flows, during the fourth quarter of 2021 these continued to follow the pattern they have displayed since the beginning of the pandemic, dipping below historical trends, and in some quarters, registering outflows. According to the latest available information, at the beginning of 2022, Mexico's portfolio flows resumed their downward trend but then recovered again in March 2022.

Regarding commercial banks, the banking system's total regulatory capital increased more than its risk-weighted assets between September 2021 and March 2022. Thus, the banking system's Capital Adequacy Ratio (CAR) continued to increase, a development that keeps these institutions, in general, in a sound position to face possible adverse scenarios. As for commercial banks' risks, those related to liquidity, credit and contagion have declined, while market risk has increased at the margin. This sector has thus continued to contribute to the overall financial system's resilience and generally solid position. Nevertheless, it will be important to monitor the evolution of these banks' positions.

Development banks and other development financial institutions remain financially sound, registering greater increases in their Capital Adequacy Ratio (CAR) and net profits than in the previous year, while maintaining a smaller loan portfolio.

Financing provided by other financial intermediaries continues to contract as of the end of March 2022, and certain risks persist. In particular, the impact of the pandemic and the slow recovery in economic activity has been more pronounced for this type of

financing, especially that directed to firms. Throughout the pandemic, some of these intermediaries experienced an increase in delinquency rates and a fall in profitability. Since these institutions currently are relatively small and are not closely interconnected with the country's banks, they do not pose a risk to financial stability. Given the challenges they continue to face, the possibility of some of this sector's entities being negatively affected cannot be ruled out. Therefore, it will be important to continue monitoring their situation as well as their interconnections with the rest of the financial system.

This *Report* analyzes the following macro-financial risks to financial stability: i) a faster tightening of global financial conditions, given the monetary policy adjustments implemented in several economies, in response to more persistent global inflationary pressures; ii) lower-than-expected global economic growth, with implications for the post-pandemic recovery; iii) a prolonged and more accentuated weakness in domestic consumption and investment; and iv) possible adjustments in sovereign and Pemex's credit ratings. In addition to the risks already described, there are also cyber risks, which have been increasing globally.

This edition of the *Report* expands on the analysis that Banco de México has been presenting on climate-related risks and sustainable financial assets since 2018. In particular, a scenario analysis that explicitly considers the impact of physical risks associated with climate change is included.

Stress tests are also conducted to evaluate the resilience and loss absorption capacity of Mexican banking institutions under extremely adverse, but plausible, scenarios. The stress tests consider four sets of macroeconomic scenarios consistent with the macro-financial risks presented in this *Report*, and three sets of historical scenarios qualitatively similar to past crisis episodes faced by the Mexican economy.

The stress test results show that, with Mexico's banking institutions' current capitalization index, for each of the seven considered scenarios, the system as a whole finishes the simulation horizon with capital levels amply exceeding regulatory minima (including

capital supplements). However, at the individual level, certain banking institutions, representing a low percentage of the system's total assets, could experience a greater negative impact on their capitalization levels in some of the simulated scenarios. Similarly, banking institutions' leverage ratio in aggregate would be on average, and in all simulated scenarios, above the regulatory minimum of 3%, although some individual institutions would end the simulation horizon below this level.

During the period covered by this *Report*, the liquidity and financing measures implemented by the authorities in response to the COVID-19 pandemic concluded. These measures contributed to a more orderly behavior of markets during the most critical period of the pandemic. Since their announcement, these measures granted resources and regulatory exemptions that provided additional support to financial intermediaries, fostering their orderly operation, even for those who did not make direct use of the facilities.

Banco de México will continue to monitor the evolution of financial markets in Mexico, and take the necessary actions, in strict compliance with the legal framework and in coordination with other financial authorities, to maintain the stability of the financial system and the proper functioning of the payment systems.



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