BANCO DE MÉXICO

Executive Summary

Financial Stability Report

June 2019

Summary

Banco de México's primary objective is to seek the stability of the purchasing power of the Mexican peso. The Bank also has the purpose of promoting the sound development of the financial system and fostering the proper functioning of the country's payment systems. In pursuing these objectives, the Bank oversees the Mexican financial system and its participants as well as the main risks and vulnerabilities that could affect its adequate functioning. The analysis of these issues is communicated to the public through the *Financial System Reports*. Monitoring the risks that could affect financial stability as well as their proper identification and disclosure is essential to mitigate them and thus contribute to the preservation of a stable financial system.

In order to identify the risks and vulnerabilities that could affect Mexico's financial stability and to have a more comprehensive, timely and forward-looking assessment of the financial system as a whole, Banco de México's Governing Board decided to modify the name, structure and publication frequency of this *Report.* These changes will allow to inform on the evolution of such risks and vulnerabilities in a more opportune manner. As of the present edition, the *Report* will be published twice a year and will change its name to *Financial Stability Report*. This way it will be possible to further deepen the analysis and monitoring of the potential risks and vulnerabilities for financial stability and the policies implemented to mitigate such risks.

A stable financial system is one in which financial institutions, markets and their infrastructures facilitate the exchange of funds among savers, borrowers and investors, with adequate risk management, thus contributing to the proper functioning of the economy and to achieving sustainable economic growth. Financial stability also implies that the financial system is able to withstand shocks while it also contributes to maintain an environment of macroeconomic stability and growth. An adequate functioning of the financial system also contributes to Banco de México's primary objective of ensuring price stability since it promotes a more efficient operation of monetary policy's transmission channels.

It is important to highlight that Mexico's efforts regarding financial regulation and supervision over the last years, together with a prudent conduction of macroeconomic policies, have contributed to the moderate and stable growth of the Mexican financial system. Such efforts have preserved the system's solvency and liquidity, with limited risk levels, despite a complex economic environment caused by both global and domestic factors. Notwithstanding the above, challenges in terms of financial inclusion and competition continue to persist.

Since the publication of the last edition of the *Financial System Report* in October 2018, the Mexican economy has faced an environment of high uncertainty. Regarding the international environment, the most outstanding risk factors include the escalation of trade conflicts between the United States and China; a sharper-than-expected slowdown of the global economy; the temporary tightening and subsequent loosening of financial conditions; and, political instability in some countries. As to the domestic environment, the prevailing uncertainty led to a high volatility in domestic financial markets; a depreciation of the Mexican peso; and, to risk premia increases in the last quarter of 2018. Among the factors that contributed to such behavior are the pending ratification of the United States-Mexico-Canada agreement (USMCA); the uncertainty regarding the effects of certain public policies on investment - such as the announcement of the cancellation of the New Mexico City International Airport (NAIM, for its acronym in Spanish); changes in public policies in certain areas and sectors, like the energy sector; and, the uncertainty regarding Petróleos Mexicanos' (Pemex) credit outlook.

However, since mid-December, the performance of domestic financial markets improved, partly due to the NAIM bond buy-back offer and the approval of the 2019 Economic Package by the Mexican Congress, which considers a primary surplus of 1% of GDP. Although these factors contributed to improve financial markets' sentiment during the first months of 2019, this trend has reversed in recent weeks due to the intensification of the U.S.-China trade conflict; the tensions and possible affectations in the U.S.-

Mexico trade relationship, as well as the announcements made by certain rating agencies, downgrading their credit ratings and their outlook on Pemex's and on the country's sovereign debt.

Specifically, two agencies reviewed their credit outlook for Mexico's sovereign rating to negative and one downgraded it by one notch. The agencies based these reviews on: i) the uncertainty regarding the implementation of public policies and their effect on investor's confidence; ii) the changes regarding energy policy; and, ii) the uncertainty concerning Pemex's financial situation and business plan. The rating agencies also mentioned that such factors could potentially affect public finances and economic growth. As for Pemex's debt, so far this year, two rating agencies reviewed their credit outlook from stable to negative. Another agency reviewed its rating downwards by three notches, placing it below investment grade. This rating agency stated that its review is consistent with: i) the one-notch downgrade of Mexico's sovereign rating; ii) the continuing deterioration of the state-owned company's financial profile; and, iii) the lack of investment to revert the decline in its oil production capacity. The deterioration of the sovereign credit rating and of Pemex's credit outlook is a significant risk factor that must be addressed.

In this context, since October 2018 to date, period covered by this *Report*, Banco de México, in accordance with its mandate of ensuring price stability, adjusted its monetary policy stance in order for the target rate to be consistent with the convergence of headline inflation to the 3% target within the time frame in which monetary policy operates. The monetary policy response contributed to the orderly adjustment of domestic financial markets. Thus, notwithstanding the environment of uncertainty, lower growth and higher domestic risk premia, the Mexican financial system adjusted in an orderly manner and maintained adequate levels of capitalization and liquidity, without a significant deterioration of asset quality.

Given the complex environment the Mexican economy continues to face, this edition of the *Financial Stability Report* focuses on five risks to the financial system: i) a greater slowdown of global economic growth; ii) the adoption of further protectionist policies worldwide; iii) lower levels of investment and lower growth of the Mexican economy; iv) further reviews on credit ratings in Mexico; and, v) additional episodes of volatility in international financial markets that may lead to portfolio rebalancing in emerging economies. In this environment, the potential vulnerabilities for the financial system, measured through the heat map of the Financial Vulnerability Index (IGVF, for its acronym in Spanish), introduced in the previous edition of this *Report*,[1] continue to be limited and have exhibited some improvement.

During the period analyzed in this *Report*, the slowdown of the peak phase of the financial cycle continued, which is consistent with the narrowing credit gap observed during such period. The financial position of Mexican households continued trending upwards, while aggregate households' leverage drawn from credit bureaus' data remained stable. Additionally, consumer credit continued to slowdown, due mainly to lower growth of personal loans and, to a lesser extent, of credit cards loans. In contrast, total mortgage lending increased during this period. As for delinquency rates, both consumer and mortgage lending rates remained stable during the period covered by this *Report*.

Regarding non-financial private firms, some indicators suggest that these firms may be postponing their investment plans, in line with the prevailing environment of low global growth and high uncertainty. Thus, since the last *Report*, total financing to non-financial private firms showed a significant deceleration, largely due to a reduction in external financing. In this context, Small and Medium Enterprises' (SMEs) delinquency rates continued to increase. However, the overall delinquency rates of non-financial private firms remained stable due to the low share of SMEs in the portfolio of this segment. Listed non-financial firms maintain a robust financial position, their leverage indicators showed an improvement, and their debt indicators

[1] See Box 3: Heat map of financial system risks, Financial System Report 2018.

remain at moderate levels, despite the slight increase registered during the first quarter of the year.

In regards to State-owned companies, CFE and Pemex are highly leveraged. Given the relevance that the latter company may have for financial stability, it is important to highlight that the rating agencies have reviewed both the company's debt rating and outlook, and even one agency downgraded Pemex's rating below investment grade. According to these agencies, such rating actions responded to: i) the company's weak financial position that has resulted in lower capital investment in activities that could mitigate the fall in oil production and oil reserves; and, ii) the financial measures announced by the government to support Pemex, which seem to have a limited scope, in particular as to addressing business and long-term risks.

Given the changes to the rating and outlook of Pemex's debt, strengthening its credit quality is crucial. In addition to the measures announced by the Federal Government, an adequate business plan that increases oil production and strengthens the company's financial position in the medium and long term is required, since these are key elements to reduce the risks faced by public finances and the country's financial system. A more robust financial position by Pemex would contribute to relieve pressure on public finances and lower the risk of further reviews on Mexico's credit rating.

Commercial banks continue exhibiting sufficient levels of regulatory capital and liquidity ratios to deal with episodes of financial stress. During the period covered by this *Report*, banks' credit risk slightly decreased and although market risk increased over the last months of 2018, it has been decreasing due to banks' portfolio restructuring since the first quarter of 2019. Commercial banks' maintain sufficient liquidity and comply with the established standards of Liquidity Covered Ratios (LCRs) and Net Stable Funding Ratios (NSFRs), despite the fact that requirements based on the latter indicator have not yet entered into force in Mexico.

Just like commercial banks, development banks and other development financial institutions have the necessary financial strength to deal with possible adverse scenarios. It should be noted that the countercyclical role of these institutions during adverse scenarios has been essential. The system has adequate capitalization levels that consequently offers sufficient slack for these institutions to provide financing if necessary. It will therefore be important to monitor credit growth and origination standards of their loan portfolio, as well as the implementation of new products, and to rely on an adequate risk management strategy.

It is worth noting that financing provided by other non-bank financial intermediaries, such as Savings and Loans' Cooperatives (Sociedades Cooperativas de Ahorro y Préstamo, SOCAPs), People's Finance Corporation (Sociedades Financieras de Préstamo, SOFIPOs), credit unions, financial firms, department store credit, and, more recently, the business sector analogous to FinTech, continued to increase during the analyzed period. Although these institutions' growth is based on a relatively small asset size, from a financial stability perspective it is very important to monitor this sector due to its interconnections with the financial system entities. Otherwise, in situations of financial stress, the non-regulated financial sector could affect the entire financial system.

Based on the analysis presented in this Report, it is possible to conclude that the Mexican financial system has sufficient capital and liquidity ratios and exhibits moderate risk levels. However, there are still considerable risks that could eventually have an impact on the system's stability.

In addition to the above mentioned risks, cyber risks must also be considered. In recent years, attacks to the financial sector's information technology systems have steadily increased worldwide. In addition to their potential of severely damaging financial institutions, their users and the overall financial system, attacks of this nature may have a systemic impact when they affect financial market institutions and infrastructures. Similarly, new technologies in the financial services industry have significant implications and pose important challenges to the traditional functions of central banks.

The risks imposed by climate change on financial system participants must be taken into consideration as well. Although the current estimates of possible losses for the financial system stemming from climate change vary greatly, they may threaten the financial system's stability under extreme scenarios. For this reason, it is important that financial institutions adopt a more active role that allows them to size, absorb and mitigate such risks.

As in previous editions of this *Report*, stress tests are used to assess the banking system's resilience against extreme but plausible shocks of low probability of occurrence. The analyzed scenarios consider extreme events associated with the previously described risks faced by the financial system, particularly: i) a further slowdown of the economy; ii) additional downgrading of Mexico's credit ratings; iii) a possible deterioration of the North American trade relationship and the absence of a trade agreement for the region; and, iv) extreme historical adverse scenarios. Such simulated scenarios are not forecasts and their results allow for assessing commercial bank's resilience. The overall results of these exercises suggest that the banking system is robust enough to face adverse events.

As to macroprudential tools, the authorities continue working on implementing them to reduce the probability of certain risks from materializing or mitigate their impact if they were to occur.

Given the various challenges the Mexican economy faces, it is important to highlight the relevance of preserving a stable, efficient, competitive and innovative financial system that generates the right incentives for financial institutions to intermediate safely and efficiently public savings to profitable projects. To achieve these goals, a strong institutional framework in addition to financial regulation and supervision that safeguard the integrity of the entire financial system and protect the population's interests are essential. All of the above is needed in order for the financial system to contribute to sustainable economic growth and increase Mexicans' welfare.

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