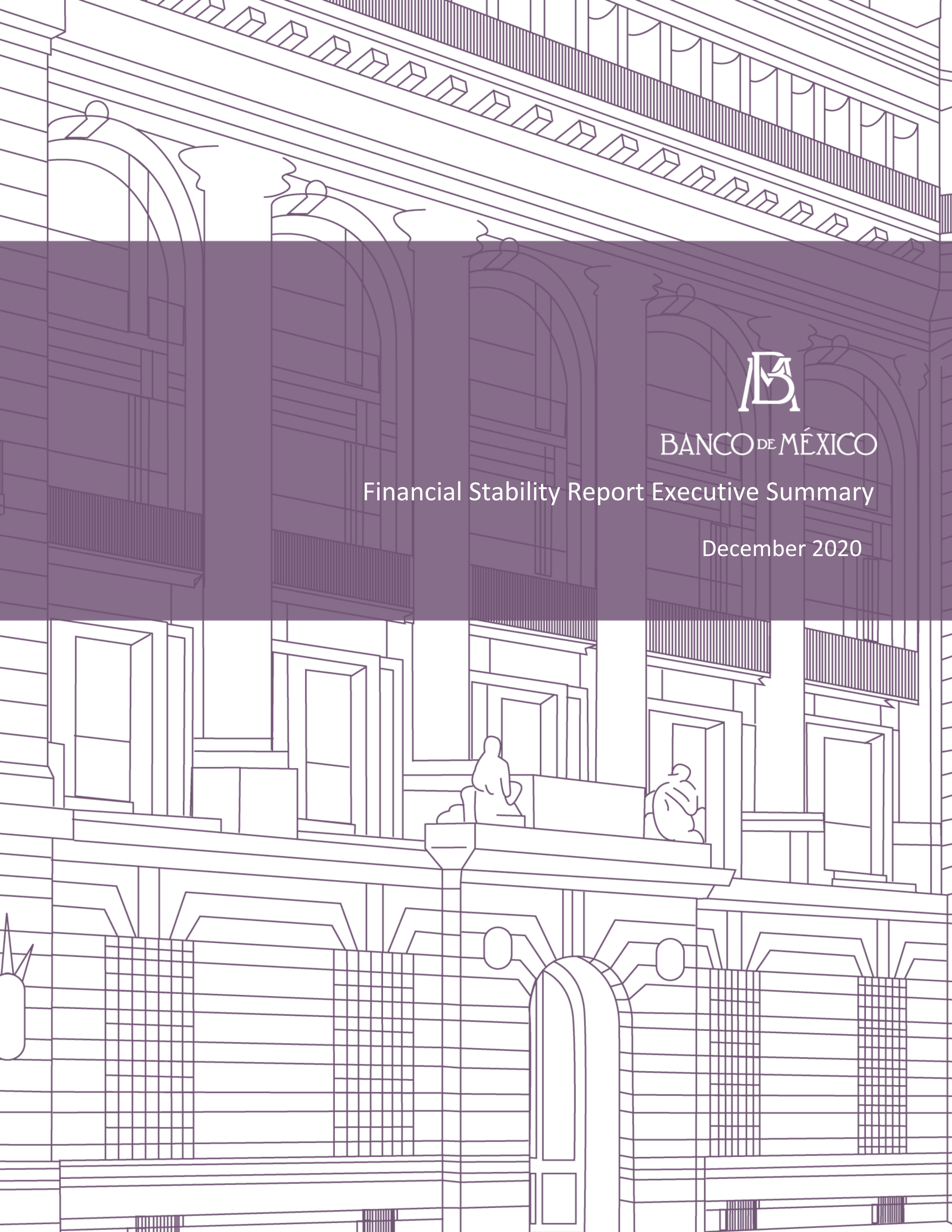

BANCO DE MÉXICO

Financial Stability Report Executive Summary

December 2020

Executive summary

The COVID-19 pandemic has led to an unprecedented situation at the global level, which has considerably affected daily life and economic activities worldwide. In particular, lockdown and social distancing measures adopted to limit the spread of the pandemic have had an adverse effect on economies, disrupting value chains and paralyzing several productive sectors. As for Mexico, the economy and financial system continue to face a complex environment due to the shocks from the pandemic that have affected economic activity, inflation and financial conditions, albeit at different time horizons. In light of the severity and the lasting impact of these shocks, which have been longer than initially anticipated, it is even more important to have a stable and efficient financial system that facilitates interaction across different economic agents and financial markets and allows for an adequate transmission of monetary and financial policies to the rest of the economy.

Although world economic activity contracted sharply during the second quarter of the year, it started to recover during the third, mainly due to the reopening of several economic activities. This recovery has been partial and heterogeneous across countries and sectors, and significant uncertainty persists regarding the pace of economic recovery in the coming quarters, particularly in light of the surge in COVID-19 infection rates that has restarted lockdown measures in several countries, and the challenges posed by the eventual approval, distribution and administration of vaccines.

In this context, after the volatility observed in March and April, international financial markets have performed positively since May, reflecting both the gradual reopening of economies and the effects of fiscal, monetary and financial stimulus measures adopted by the main advanced economies, which, in turn, fostered a more favorable environment for emerging economies. Subsequently, as of mid-September, episodes of volatility were observed. This was associated mainly with the increase in COVID-19 infections in some regions, the possibility that economic recovery will moderate in the future, a lower probability that a fiscal package is approved in the United States, as well as geopolitical factors. In recent weeks, however, financial markets have performed better due to more positive expectations associated with testing and the degree of progress in developing COVID-19 vaccines. In this context, the increase in Mexico's financial market stress index and financial conditions index during March and April have partially reversed. It is probable that both global and domestic financial conditions will continue to depend mostly on the evolution of the pandemic.

In this context, Mexico's financial system continues to face significant challenges related to market operations, the flow of credit to the economy, the containment of liquidity problems, and adequate risk management.

This *Report* describes the current situation of the financial system, as well as the evolution of the most important risks and vulnerabilities faced by financial institutions and the system overall as a result of the pandemic. It also describes the measures implemented to promote the healthy development of the financial system and preserve its stability in the current complex environment. It is worth noting that the adequate identification and timely monitoring and reporting on the risks faced by the financial system allow policymakers to take the most appropriate mitigation actions, contributing to the preservation of Mexico's financial stability and enabling its financial system to fulfill its intermediation function, thus helping to mitigate the impact on economic activity.

Banco de México, in coordination with other financial authorities, has implemented a wide range of measures to address the challenges that have affected domestic financial markets and to improve trading conditions. During the second half of the year, it decided to adjust the framework of some of these measures, as well as to extend their duration, in order to continue preserving the sound development of the financial system and contribute to maintaining the flow of credit to the economy.

The impact of the pandemic on economic activity and the measures implemented to contain it, have affected employment and household income levels. Under these circumstances, households with lower incomes, a smaller base of savings or whose income depends on the most affected sectors and firms, tend to be more vulnerable. In this regard, since different financial intermediaries meet the needs of different segments of the population, the risks associated with the payment capacity of firms and households are also heterogenous across intermediaries.

In this context, credit to households during the second and third quarters of the year slowed down. This trend is associated with both supply and demand factors and is mainly explained by the decline in consumer credit. Delinquency rates in the consumer credit portfolio decreased in all segments due to banks writing off non-performing loans. Personal loans continue to be the segment with the highest delinquency rates. In contrast with consumer credit, housing credit continued to grow in 2020, although at a slower pace. The delinquency rate of this portfolio remained at relatively low levels.

After having grown at a faster pace during the first quarter of the year, total credit to Mexico's non-financial private enterprises slowed down during the second and third quarters of 2020; however, as of September, it remained slightly positive on a year-on-year basis. In particular, credit to small- and medium-sized enterprises (SMEs) continued to contract during the same period, reflecting a reduction in credit, particularly for new borrowers. Nevertheless, the SME's delinquency rate decreased as of June, as a result of banks writing off loans. Delinquency rates of large non-financial private firms have remained stable in recent months, despite a temporary increase generated by some defaults.

As to the public sector's financial position, between January and September 2020, its balance registered a deficit below the level originally budgeted in the 2020 Economic Package. This was the result of both lower budget revenues and lower spending vis-à-vis those expected in the Federal Revenue Law. As for state-owned productive enterprises, the fall in crude oil prices, as well as a lower production, led to a reduction in Pemex's annual revenues during the third quarter. Given the current economic conditions, it is essential for Pemex to continue strengthening its financial position.

During the second and third quarters of the year, the financial account balance registered capital outflows. During the third quarter of 2020, the latest information from the Institute of International Finance (IIF) suggests that although non-resident portfolio flows recovered in August, there were outflows in September, and debt outflows were registered during October.

It is worth noting that commercial banks' capitalization levels increased between March and September 2020. This was due to both a greater dynamism in the capital generated by these institutions, derived from their financial results and from a reduction in risk-weighted assets. This increase was also due to the fact that most banking institutions did not issue dividends, in line with the recommendation issued by the National Banking and Securities Commission (CNBV, for its acronym in Spanish), in order to have a solid capital base that would allow them to face the recent situation in a better position.

As to commercial banks' risks, some credit risk metrics increased due to the higher risk of consumer and private sector's credit portfolios, although the impact of the pandemic on delinquency rates has been limited so far.

Overall, market risk has decreased significantly since March 2020. While liquidity risk for some institutions increased at the beginning of the pandemic, institutions generally had ample liquidity reserves to face said risk. As of the second quarter of 2020, after the initial shock generated by the pandemic-related uncertainty, the financial system's liquid reserves, particularly those of larger banks, have increased. Medium and small banks also have maintained adequate levels of liquidity on average, despite the challenges faced during the second half of the year. The risk of contagion in the interbank market has followed a slightly decreasing trend since the release of the last *Report*. The number of interconnections among intermediaries has decreased, although the importance of some financial institutions, mainly large ones, has increased.

Development banks and financial institutions remain financially sound, which is reflected in the positive evolution of the main balance sheet and income statement items, as well as in various financial indicators. However, the results have been affected by the COVID-19 pandemic. In particular, development institutions implemented several measures, such as the establishment of preventive estimates for credit risks to face a possible deterioration in credit portfolios, to support the sectors they serve and to mitigate the deterioration of their portfolios. Overall, development banks have sufficient liquidity levels, although some related indicators have slightly deteriorated. According to development banks' estimates, the impact of the pandemic may be absorbed by the profits generated during the year. However, it would be worth evaluating the institutions' capital strategy for portfolio growth. In this context, it is worth noting that financing by development banks has the potential to mitigate the credit effects associated with economic contractions, as long as it is used to finance socially profitable projects with appropriate recovery conditions.

Although the risks to the financial stability of other non-bank financial intermediaries are estimated to be limited, some entities in this sector could be affected. This is due to the sectors they serve and the fact that several of these intermediaries are in a less resilient financial position. Therefore, given the challenges posed by the pandemic, it is necessary to continue monitoring their situation and their interconnections with other entities in the financial system.

This document analyzes four macro-financial risks for the financial system: i) a less vigorous than anticipated recovery of the global economy, particularly in the United States, ii) greater volatility in international financial markets and a recomposition of flows towards lower risk assets, iii) a slower recovery of the domestic economy and, iv) a downgrading of sovereign and Pemex's credit ratings.

In addition to the risks described above, there are those related to operational continuity due to the lockdown and remote working measures implemented by several financial institutions during the pandemic. Similarly, a higher number of remote connections required for remote working schemes, has contributed to a higher exposure to cybersecurity risks. In this context, cybersecurity measures have been strengthened and are monitored more closely to ensure the proper functioning of financial institutions overall and of financial market infrastructure in particular.

While the risks posed by the COVID-19 pandemic have been highlighted in this *Report*, it is worth noting that there are other risks, such as those related to the sustainability of investments and environmental risks, although they operate over a longer horizon. Given the relevance of environmental and climate risks for the financial system, the process for properly identifying and assessing risks by financial institutions and authorities has accelerated. For this reason, this *Report* describes some consequences of banks' exposure to some of these risks.

As in previous editions, this *Report* includes stress results. The purpose of this exercise is to assess the banking system's resilience in the event of specific macroeconomic and financial shocks. It is important to note that the stress tests are not Banco de México's forecast of banks' potential losses. The tests seek to analyze –subject to a considerable shock and under unique circumstances- the effect on banks' capital, under the assumptions of each stress scenario. This exercise is common among all institutions and does not take into account idiosyncratic problems regarding loan origination or the response of each institution to a scenario such as the one evaluated. Therefore, its results are to be considered at the system level, rather than at the individual level.

To assess aggregate capital levels, sets of scenarios consistent with the balance of risks were considered in this *Report.* These scenarios were also designed to assess the system's resilience as of September and over a period of 36 months in an environment of slow economic recovery. The results suggest that the banking system as a whole has sufficient capital levels that would allow it to face the different adverse macroeconomic and financial scenarios simulated for the Mexican economy. At an individual level, some banking institutions, which represent a low percentage of the system's total assets, may have difficulties in maintaining the minimum regulatory capitalization levels. As for the system's leverage ratio, it would remain above 3%.

In summary, the Mexican financial system as a whole has shown resilience in the face of the adverse conditions that have arisen. However, uncertainty persists about the effects of the pandemic on the credit portfolio of the most vulnerable sectors; thus, special monitoring of the sectors or segments that suffered the greatest impact on their income is required, as well as monitoring the risk that the concentration in their sources of financing represents for some institutions.

In this environment, the Mexican financial authorities have implemented a wide range of measures to maintain an adequate operation of the financial system and reduce a pro-cyclical response of financial institutions. Measures have been announced to promote an orderly functioning of financial markets, strengthen credit channels, and supply liquidity for the sound development of the financial system.

Banco de México will continue to follow closely the evolution of financial markets in the country and will continuously assess their operating conditions. In strict compliance with the legal framework and in coordination with other financial authorities, it will continue to take the necessary actions to maintain the stability of the financial system and the proper functioning of the payment systems. Looking ahead, the challenge will be to maintain a sound financial system that will be able to fulfill its intermediation function and contribute to a faster and vigorous recovery.

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