



BANCO DE MÉXICO®

# Executive Summary of the Financial Stability Report

December 2022

## Executive summary

The Mexican financial system continues to be in a solid and resilient position. In particular, commercial banks have capital and liquidity levels well above regulatory minimums. Nevertheless, the current international environment has become more complex and uncertain, characterized by high levels of inflation, a deteriorating growth outlook, tighter global financial conditions, and risks to financial stability in advanced economies.

Throughout 2022, economic activity in Mexico has continued to gradually recover. Thus, as of the third quarter of 2022, GDP is already at levels similar to those observed in the fourth quarter of 2019, prior to the public health emergency.

With respect to the global economy, the International Monetary Fund's (IMF) growth estimates for 2023 were revised downwards. These adjustments were made in response to expectations of tighter global financial conditions caused by interest rate increases, the possibility of a further slowdown in China due to the worsening of the real estate crisis and the country's strict lockdowns resulting from COVID-19, as well as the effects that the military conflict between Russia and Ukraine has had on European energy markets. Global inflation rates increased, with rapid increases in food and energy prices.

In an environment of persistently high inflation, expectations of lower economic growth, greater uncertainty regarding the evolution of global financial conditions, and geopolitical tensions, monitoring the evolution of the financial system 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.

International financial markets have been affected by the challenging environment, exhibiting episodes of high volatility and greater risk aversion, as well as a significant tightening of financial conditions. This financial tightening occurred due to a faster pace of monetary policy adjustment by the main central banks in response to persistently high readings on

inflation and to upward revisions of inflation expectations.

In particular, financial markets in emerging economies have been affected. Since June 2022, these economies' currencies have depreciated against the US dollar. The Mexican peso, however, has remained the only currency in this group that appreciated during the period. This is primarily due to the following factors: the Mexico-US interest rate spread compared to the spreads for other economies, Mexico's relatively prudent implementation of fiscal and monetary policies, and its balanced external accounts.

In this environment, certain aggregate risk indicators increased slightly since the last *Report*. The Mexican Financial Markets Stress Index (IEMF, for its acronym in Spanish), albeit showed some improvements during the period, registered levels similar to those observed in June 2022 and is still above its pre-pandemic level. Meanwhile, the domestic Financial Conditions Index (ICF, for its acronym in Spanish) tightened between June and October 2022 and was mainly driven by the hike in domestic interest rates resulting from inflationary pressures. A similar behavior was also observed in the financial conditions indexes of other countries. Uncertainty persists regarding the future evolution of financial markets, and new episodes of deteriorating financial conditions cannot be ruled out possibly affecting capital flows to emerging market economies, including Mexico. Firms and households' financing costs could thus possibly increase.

Certain vulnerabilities and risks for the domestic financial system, which arose during the pandemic, have been diminishing. Among these, according to data up to November 2022 for an economic policy uncertainty index based on Twitter, uncertainty associated with the country's economic policy decreased compared to six months earlier and is at a relatively low level compared to those observed over the last three years.

Total financing in the economy contracted in real annual terms during the third quarter of 2022. Financing for household consumption registered an increase, while mortgage loans and financing to the

public sector contracted. The financing gap has registered six quarters with negative figures.

During the second and third quarters of 2022, consumer credit granted by commercial banks and their subsidiary sofomes continued recovering, registering positive annual growth rates in practically all its segments. In contrast, as of September 2022, total mortgage loans decreased in real terms with respect to the prior year. Total financing to non-financial private firms in Mexico also continued decreasing in real terms, both the external and domestic components. Both sources of financing have been decreasing for eight consecutive quarters. The contraction in external financing is mainly attributed to a reduction in bond issuance in international markets.

Regarding the public sector's financial position, in January-September 2022, the budget deficit was lower than planned for in the 2022 Economic Package, although both revenues and budgetary expenditure were higher than projected. As for state-owned enterprises, at the end of the third quarter of 2022, Pemex registered a quarterly loss lower than that observed during the same quarter of the previous year. In addition, a credit rating agency downgraded the company's global scale rating on July 11, 2022 highlighting its high liquidity risk, as well as its high dependence on support from the Federal Government. Meanwhile, the Federal Electricity Commission (CFE, for its acronym in Spanish) registered at the end of September 2022 a quarterly loss larger than that observed in the same quarter of the previous year, in response to the increase in fuel prices associated with the military conflict between Russia and Ukraine. In July 2022, two rating agencies downgraded the company's individual credit profile by one level. The company's overall rating is equal to the sovereign rating and maintains its investment grade.

In April-June 2022, inflows remained below their historic trend, although exhibiting some improvement with respect to recent periods. Commercial banks' assets recovered during 2022, which, to a large extent, reflects the recent expansion of their credit portfolios. However, the current environment of uncertainty could lead to a new reconfiguration of commercial banks' balance sheets.

The recovery of the credit portfolio, as well as the increase in funding costs, was reflected in higher, although differentiated, financial margins of commercial banks.

With respect to March 2022, liquidity, credit and bank-contagion risks have decreased, while market risk has increased. Specifically, during the second half of 2022, both the capitalization and the liquidity position of the Mexican banking system have remained far above the regulatory minimums. This sector has thus continued to contribute to the overall financial system's resilience and generally solid position. Nevertheless, under the current environment, it will be important to monitor the evolution of these banks' positions.

Development banks and other development financial institutions remain financially sound. Despite having a smaller loan portfolio and greater holdings of reserves, the health of these entities reflects the favorable evolution of their main balance sheets and financial statement items. They registered higher net profits, mainly obtained from higher income from investments in financial instruments and portfolio interest.

Risk indicators of other non-bank financial intermediaries (OIFNB, for its acronym in Spanish) are relatively stable. However, the outlook for some of them has deteriorated in view of the conditions prevailing in both the global and domestic environment. The situation in the non-regulated sector poses complex challenges, such as reduced access to financing due to the materialization of certain credit events and the tightening of both local and global financial conditions. This sector's assets represent a small fraction of the financial system and there is limited interconnectedness among these institutions, the country's banks and other institutional intermediaries. Hence, they do not represent a factor for systemic risk.

This *Report* analyzes the following macro-financial risks to financial stability: i) a greater and faster tightening of global financial conditions; ii) lower-than-expected global economic growth, characterized by a downward trend; iii) a further weakening of aggregate demand; and iv) additional negative adjustments of credit ratings for both sovereign debt and Pemex.



Stress tests were also conducted to evaluate the resilience and loss absorption capacity of Mexican banking institutions under extreme adverse, but plausible scenarios. As part of the stress tests conducted in this *Report*, three sets of macroeconomic scenarios consistent with the macro-financial risks presented in this document are considered, as well as three sets of historical scenarios qualitatively similar to crisis episodes that the Mexican economy has faced. The results show that the capitalization index of banking institutions in Mexico would allow the system, at the aggregate level and in the six scenarios considered, to conclude the simulation with levels well above regulatory minimum, including capital buffers. However, at the individual level, there are certain banking institutions, representing a low percentage of the system's total assets, which, in some of the simulated scenarios, could see deteriorated capitalization levels. The leverage ratio of banking institutions would be, on average and in all simulated scenarios, above the regulatory minimum of 3%, although some institutions would end the simulation below this level.

In addition to the risks described above, there are others related to financial institutions' operations, such as business continuity risk. These have been closely monitored in recent years by the financial system in general and within Banco de México, in particular. Cyber-risks are equally important, as they have been increasing at the global level. As for Banco

de México, the financial market and payment systems infrastructures it manages and operates have maintained high levels of operability, with no incidents reported in either their technological infrastructure or in their operating processes. Cyber-risks continue increasing and have become one of the major non-financial risks to the global financial system, with a high potential to have a systemic impact and affect financial stability, if they were to occur. With this in mind, Banco de México has implemented tools that allow for permanently monitoring the levels of cybersecurity in Mexico's financial system.

The economic and financial impact of climate change can lead to considerable future losses for financial institutions and pose a risk to the financial system overall. To strengthen the resilience of the financial system to these eventualities, Banco de México has been actively working on making Mexico's financial system participants include climate-related risks in their risk management practices. Banco de México is also continually improving and developing tools and conducting analysis related to climate change.

Finally, Banco de México will monitor the evolution of Mexican financial markets and will continue taking actions, in compliance with the legal framework and in coordination with other financial authorities, to preserve the stability of the financial system and the proper functioning of the payment systems.



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