BANCO DE MÉXICO

Financial Stability Report Executive Summary

June 2020

Executive summary

Since the publication of the previous *Financial Stability Report* in December 2019, the outlook for Mexico's economy and financial system has deteriorated due to the COVID -19 pandemic. Health measures implemented both worldwide and domestically in reaction to the health crisis have helped to contain the virus, but have also affected global economic activity and international financial markets significantly.

Since late February, the economic and financial environment has become more complex and uncertain. Domestic financial markets exhibited a negative performance, in line with the situation observed in international financial markets, due to a significant increase in risk aversion. In particular, trading conditions in foreign exchange and fixed-income markets deteriorated, exhibiting a lack of depth and low levels of liquidity. The significant fall in oil prices due to a combination of weaker economic activity, coordination failures among the main oil suppliers, and excess inventories, also contributed to the deterioration in financial markets. In this environment, the main rating agencies downgraded Mexico's sovereign debt and Pemex credit ratings. Foreign holdings of both fixed-income and equity assets denominated in pesos declined. However, in recent weeks domestic financial markets have performed better. In particular, government securities registered lower interest rates along the yield curve, and the peso/US dollar exchange rate appreciated and exhibited lower volatility. Nevertheless, significant risks persist.

The evolution of financial conditions has been reflected in aggregate risk indicators. In particular, Mexico's financial market stress index and financial conditions index have increased sharply since the end of February. This increase was due to the high volatility in global and domestic financial markets as a result of the global spread of COVID-19. However, such indicators have recently shown some improvement, partly due to the appreciation of the peso exchange rate.

Social distancing and lockdown conditions have caused a significant reduction in some firms and households income levels, which has generated a need for liquidity in the short term. The impact that this situation may have on the financial soundness of non-financial private firms will depend on several factors: the direct effect of the pandemic on the sector to which these firms belong; the effect of the measures implemented by the Federal Government and financial authorities on each sector, and the specific features of each firm –their size, liquidity, leverage, and credit quality. As for households, unemployment has increased significantly and labor participation has decreased markedly, trends which are expected to intensify further. If households also face credit constraints or reduced access to credit, aggregate demand could decrease further and for a longer time than what would have resulted from social distancing and lockdown measures alone. All of the above may lead to higher levels of delinquency in the private sector's credit portfolios. It is precisely in these circumstances that the financial system can fulfill its function of mitigating the negative effects that a shock such as the one related to the pandemic may have on the economy. That is, it serves as a bridge that allows the channeling of resources and financing required by economic agents to face the health emergency.

Among the main challenges currently confronting the Mexican financial system, the following stand out: avoiding exacerbating any operational and liquidity problems that economic agents may face; maintaining the flow of credit to firms, households and certain financial intermediaries as they require, and maintaining adequate liquidity conditions in both domestic and foreign currency markets. Likewise, it is essential to have good trading conditions in domestic financial markets and foster the proper functioning of payment systems. Financial intermediaries must adequately manage their market, credit, and operational risks as these increase. In this regard, Banco de México's Governing Board has implemented measures to promote the orderly functioning of financial markets, to strengthen credit provision, and to supply liquidity, for the healthy development of the financial system.

Adequately identifying and monitoring, as well as communicating in a timely manner, the risks that the financial system is facing have become even more important in this context. All of the above are key to taking the necessary actions to mitigate said risks, in order to preserve financial stability, so that the financial system can fulfill its intermediation function, in the complex and uncertain environment faced currently by the economy.

As for the economy's financial position, financing in Mexico rose during the first quarter of 2020. This result is explained by an increase in the value of external financing due to the depreciation of the peso exchange rate during the period, and by an increase in domestic financing from the use of credit lines by some firms.

During the fourth quarter of 2019 and the first quarter of 2020, household credit growth continued to slow down and, in aggregate terms, household leverage decreased slightly at the end of 2019. It is worth noting that households with lower incomes, fewer savings and whose income depends on the most affected sectors and firms, are the most vulnerable to the economic shock stemming from the shutdown of non-essential economic activities.

Total financing to Mexican private non-financial firms continued to slow down during the fourth quarter of 2019 due to a loss of dynamism in both domestic and external financing. Nevertheless, during the first quarter of 2020, both domestic and external financing to firms increased. The rise in domestic financing was possibly due to a precautionary and temporary need for more liquidity to face the health emergency. Thus, in March 2020 an increase in the use of credit lines granted by commercial banks was observed, which led to higher levels of bank credit to firms. The level of external financing rose mainly due to the effect of the peso exchange rate. It is worth noting that the health measures implemented to reduce the virus spread have led to a considerable reduction in the income of large- as well as small- and medium-sized enterprises (SMEs). This has affected particularly those firms related to the food services, accommodation, passenger transportation, recreation and entertainment sectors. All of the above has taken place in an environment of liquidity constraints and debt issuance difficulties, which may increase the refinancing risks that some firms are facing.

As to the public sector's financial position, at the end of 2019 its balance together with the Public Sector's Borrowing Requirements registered a deficit below the level budgeted in the 2019 Economic Package. As for state-owned enterprises, the sharp fall in crude oil prices led to a reduction in their annual income. Consequently, Pemex's financial situation overall continues to be under pressure as a result of lower revenues and higher expenditures. The main rating agencies downgraded sovereign debt and Pemex's credit ratings in March and April. As to Pemex's credit rating, two rating agencies ranked it below investment grade using their global scale and two also gave it a negative outlook.

As for the Mexican economy's aggregate financial position, the (net) international investment position was higher during the fourth quarter of 2019 than at the end of the same period of the previous year. Overall, in an environment of higher global and domestic volatility, there has been a recomposition of portfolios towards lower-risk assets, which has affected capital flows. During the fourth quarter of 2019, net capital inflows were relatively small. In the first quarter of 2020, mixed results were observed, with significant capital inflows in January and sizable outflows in March. Despite having slightly recovered in April, portfolio flows remained in negative territory.

It is worth noting that commercial banks' capitalization levels together with the composition of their assets and liabilities, provided margin for them to expand their activities and face the pandemic contingency in a strong position. During the first quarter of 2020, both households and firms' aggregate delinquency rates did not change significantly vis-à-vis the rates observed in 2019. Nevertheless, given the severity and depth of the crisis and the impact it may have on economic activity, this situation could change in the future. The adjustment of domestic financial markets led to a significant increase in banks' market risk in March 2020, as compared to the fourth quarter of 2019. Potential extreme losses due to adjustments in risk factors, measured as banks' net capital ratio, increased. Since 2015 commercial banks have been gradually increasing their liquidity reserves to better face an eventual stress scenario. These efforts have increased the resilience of banks individually and of the banking system overall, and allowed banks to maintain their credit flows in March and April, in the midst of the crisis associated with the pandemic. As to liquidity in foreign currency, banks continue to hold sufficient liquid assets. Meanwhile, the risk of interbank contagion has trended slightly upwards, since the publication of the previous *Financial Stability Report*, notably in March.

Bank's credit portfolio for households that are facing the highest risk of losing their source of employment and for firms most affected by the COVID-19 pandemic might be adversely affected. In this regard, temporary measures adopted to provide more flexibility in deferring payments of loan capital and interest for up to six months should maintain current portfolio levels. Nevertheless, once the implementation period of this measure ends, fostering the normalization of payments and monitoring such credits will be required.

It is worth highlighting that, in addition to the above described facilities, Mexican financial authorities have implemented a wide range of measures to prevent either regulation or financial institutions' response to the health crisis from leading to a tightening of credit when it is most needed. That is, measures have been taken to mitigate the effects of the shock associated with the pandemic on financial markets, and to allow the financial system to channel resources to households and firms for the purpose of achieving a faster economic recovery once the health emergency is over. The purpose of these measures is to avoid a pro-cyclical response in the financial system that intensifies the shock that is taking place.

As for the actions approved by Banco de México's Governing Board, apart from lowering the policy rate by 175 basis points from February to date, additional measures to support the functioning of the financial system were taken. The objectives of the implemented measures are: i) providing support to credit; ii) improving liquidity conditions; iii) ensuring the proper functioning of financial markets; iv) implementing regulatory facilities; and, v) facilitating operations and operational continuity. That is, they are intended to preserve financial system stability. The total size of the program that provides liquidity in domestic currency is equivalent to 3.3% of Mexico's 2019 GDP.

As for development banks and other financial institutions, overall they remain financially sound and prepared to face possible adverse scenarios and have the adequate tools to fulfill their mandates. Financial institutions have maintained adequate capitalization levels. Nevertheless, during periods of economic difficulties, development banks and financial institutions are expected to act as an important vehicle to implement counter-cyclical policies. Therefore, it is fundamental that proposed special programs and actions take into consideration at all times the principles of: financial sustainability, complementarity with private financial intermediaries, and alignment with their mandate according to their statutes, to promote sound practices and compliance with regulations.

Risks to financial stability from other non-bank intermediaries are estimated to be limited. Nevertheless despite the mitigating measures, the liquidity, and potentially solvency, of some sector entities may be affected, given that their current financial position is less resilient. Thus, in light of the challenges posed by the pandemic, their situation and their interconnections with other financial system entities must be monitored continually.

Although at this stage the financial system has remained resilient to the materialization of the aforementioned risks, some of these may intensify given the prevailing complex and uncertain economic environment. This is reflected in the significant escalation in the number of major risks financial institutions are expected to face in the next six months. In particular, this *Report* analyzes four major risks for the financial system: i) the impact of the slowdown of the world economy and the uncertainty associated with its recovery; ii) volatility in international financial markets and the recomposition of flows towards lower-risk assets; iii) a greater contraction of the domestic economy and uncertainty associated with its depth and duration; and, iv) an additional downgrading of sovereign debt and Pemex's credit ratings.

The *Report* also analyzes operational continuity risks. These risks are currently the most relevant of the risks faced by the financial system due to the lockdown and home office measures implemented by several financial institutions. Better practices have been proposed in the field to ensure the proper functioning of financial institutions overall and of financial market infrastructures in particular.

As in previous editions, this *Report* includes stress test 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 bank's potential losses. The tests are aimed at analyzing –subject to a considerable shock and under unique circumstances- the effect on banks' capital under the assumptions of each stress scenario. This exercise is implemented using a common procedure for all institutions and does not take into account idiosyncratic problems regarding loan origination. Therefore, its results are only relevant at the systemic, rather than the individual bank, level. This *Report* analyzes six sets of stress scenarios, three of which are related to the aforementioned macro-financial risks. To complement the analysis, the remaining three scenarios correspond to extreme historical adverse scenarios, and reflect the financial system's reaction to shocks qualitatively similar to stress periods that the Mexican economy has experienced in the past. The test results indicate that, under the considered shocks, the system's capitalization weighted index is an element of utmost importance to face an adverse scenario. In some simulated scenarios, banks' capital would be significantly eroded, risk-weighted assets would decrease, and some banking institutions may reach capitalization levels below regulatory minimums. It is worth noting that these exercises do not take into account possible mitigating actions that each institution included in the exercise may undertake. As has been pointed out in previous editions of this *Report*, the stress scenarios assessed could become more complicated or intensify depending on the interaction and feedback among the different vulnerabilities, whether they take place jointly or are deeper given the environment of marked uncertainty as the one associated with the pandemic.

At the beginning of the pandemic, the Mexican financial system had sound capital and liquidity conditions, which are essential to face an environment of economic weakness and sustain financing for firms and households. Likewise, financial authorities have implemented temporary regulatory measures to avoid either regulation or the response of financial institutions leading to a tightening of credit when it is most needed. The purpose is to avoid a pro-cyclical response in the financial system that intensifies the shock that is currently taking place. The soundness of the financial system, and its preservation in the future, will be key to facing these shocks and should contribute to an orderly adjustment of domestic financial markets and of the economy overall. Nevertheless, it is important to acknowledge that uncertainty about the impact of the pandemic may continue to affect economic activity and generate significant turmoil in 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. Strictly abiding by the legal framework and in coordination with other authorities, it will also take the necessary actions to continue fostering the sound development of the financial system.


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