BANCO DE MÉXICO

Financial Stability Report

Executive Summary

June 2021

Executive summary

Since the beginning of 2020, the Mexican economy has faced significantly adverse economic and financial conditions and an environment of high uncertainty due to the shocks caused by the COVID-19 pandemic. The conditions under which the Mexican financial system operates have also been affected. Nevertheless, in light of better prospects for the world economy, the outlook for the Mexican economy has improved.

In particular, global economic activity continued to recover during the first quarter of 2021, albeit heterogeneously across countries and sectors, and at a more moderate pace than at the end of 2020. Nevertheless, global economic growth projections for 2021 and 2022 have been revised upwards. During 2021, inflation has increased worldwide, mainly due to rising energy prices, as well as to low base effects and some cost-push pressures, in a context of highly accommodative monetary policy stances. In several countries, governments continued implementing fiscal measures to tackle the pandemic and, in some of them, new fiscal stimuli were approved. Especially notable is the case of the unprecedented fiscal package approved by the United States Congress in March 2021 for 1.9 trillion dollars. In addition, there is the possibility that the US administration will propose a budget of 6 trillion dollars for the fiscal year 2022.

Financial markets have overall exhibited a favorable performance in 2021, although episodes of volatility were observed from mid-February to mid-March. These episodes were associated with concerns about inflation in light of the fiscal stimuli implemented in the United States. This led to increases in medium- and long-term interest rates, mainly in advanced economies. This increase in interest rates has partly contributed to depreciation in the currencies of certain emerging economies, and to a tightening of financial conditions in this group of countries. Although financial markets have exhibited some stability since mid-March, long-term interest rates remain at levels higher than those observed at the beginning of the year, and the possibility of new episodes of volatility persists.

Domestic financial markets have overall exhibited a good performance during the year, albeit with some episodes of volatility from mid-February to March in response to global financial conditions. In this context, the Financial Markets Stress Index trended downwards during the period covered by this *Report*.

In this environment, the Mexican financial system has continued to show resilience and an overall solid position, characterized by capital and liquidity levels above regulatory minimums. The beginning of the vaccination campaign in the country and the continuation of a gradual recovery process have been favorable for growth prospects. The financial system is well–positioned to support the pace, scope, and robustness at which the Mexican economy recovers. However, the outlook remains uncertain and is mainly subject to the evolution of the pandemic and the possibility of continuing to observe a heterogeneous recovery.

Given the impact of the pandemic on the Mexican economy and financial system, certain vulnerabilities and risks that had increased since the beginning of the contingency, remain at levels above those observed during the first quarter of 2020.

The adverse effects of the pandemic on economic activity also have had an impact on employment and household income levels. Although recent figures point to some recovery, they still remain below pre-pandemic levels. In these circumstances, lower-income households with a small amount of savings, or those whose income depends on the most affected sectors and businesses, are the most vulnerable.

At the end of the first quarter of 2021, the balance of total financing to households contracted in real annual terms, a trend that has been observed in the last four quarters. The unfavorable evolution of consumer credit underlies this trend. From September 2020 to March 2021, consumer credit granted by banks and their subsidiary *sofomes* continued to decline for all types of loans. The dynamics of consumer credit granted by banks can be explained partly by households' precautionary behavior due to the uncertainty generated by the pandemic, which has led to a lack of dynamism in demand for credit. Tight credit supply conditions have also contributed to the overall declining trend in

household credit. In contrast, lending associated with housing continued to expand during the fourth quarter of 2020 and in early 2021, although at a slower pace in recent months.

Total credit to the country's non-financial corporate sector contracted in real annual terms during the first quarter of 2021. This contraction was due to both lower domestic and external financing. The figures partly reflect the base effects stemming from the increase in domestic funding registered during the first quarter of 2020. The latter, in particular, fell significantly during the same period in all its sources, mainly those from domestic banks. External financing, adjusted for exchange rate effects, also contracted, although to a lesser extent than domestic financing. It should be noted that there are certain differences in funding by type of company. The segment of credit to large-size companies has shown some improvement in the amount and number of new loans. Credits granted to Small- and Medium-size Enterprises (SMEs) is still below pre-pandemic levels.

As for the public sector's financial position, the public balance closed 2020 with a higher deficit than originally anticipated in the 2020 Economic Package. In the first months of 2021, the public balance registered a lower deficit than anticipated in the 2021 Economic Package. Regarding state-owned companies, Pemex's financial position has shown some improvement in recent months. This result is attributed to higher revenues along with an increase in its operating cash flow following the rise in oil prices since November 2020, and an increase in oil export volumes. A series of measures have also contributed to this result, including the fiscal stimulus for the company announced in February 2021 by the Ministry of Finance (SHCP, for its Spanish acronym). However, the company's revenues are still at pre-pandemic levels, it continues to exhibit high levels of indebtedness, and carries a significant tax burden.

Regarding foreign financial flows, the financial account balance recorded capital inflows during the first quarter of 2021, after registering three consecutive quarters with outflows. Information from the Institute of International Finance (IIF) shows that non-resident portfolio outflows were recorded during the first three months of the year. In general, emerging economies observed a dynamic of fixed income outflows between mid-February and March, although to date they have registered net capital inflows. It should be noted that China has absorbed a large part of these.

Commercial banks' capitalization levels increased between September 2020 and March 2021. This was due to both a greater dynamism in the capital generated by these institutions, derived from their financial results and a reduction in risk-weighted assets. The increase in regulatory capital was also partly due to the fact that most banking institutions did not issue dividends in 2020, in line with the recommendation by the National Banking and Securities Commission (CNBV, for its acronym in Spanish). However, last April, this authority issued new guidance to allow commercial banks to pay dividends, subject to a series of guidelines aimed at preserving sound capital levels. The reduction in risk-weighted assets was mainly due to lower current derivative transactions and a lower loan portfolio.

As to commercial banks' risks, some credit risk metrics increased during the fourth quarter of 2020 and the beginning of 2021, mainly due to an increase in credit default correlations that began with the pandemic. During this period, the delinquency rates of commercial banks' loans granted to both households and companies rose. Although credit risk is expected to continue to be determined by economic activity and employment performance, its evolution needs to be monitored, given the complex environment posed by the pandemic and the time that credit problems may take to materialize in the most vulnerable sectors. Commercial banks' liquidity, market, and contagion risks have decreased since last semester's *Report*.

Development banks and development institutions remain financially sound, as reflected by the positive evolution of the main balance sheet and income statement items. Development banks are adequately capitalized, and the sector's institutions have a Capitalization Adequacy Ratio (CAR) above regulatory capital limits, although liquidity indicators are below tolerance levels. It should be noted that the contraction in economic activity caused by the pandemic has still not affected the levels of non-performing loans significantly. In this regard, these institutions have adopted diverse measures to

support the sectors they serve and mitigate the deterioration of their portfolios.

As for other financial intermediaries' risks, although evidence provided by certain indicators is mixed, in some cases funding, indirect contagion, and to a greater extent, credit risks, have increased. However, at an aggregate level, they remain limited. In this regard, since previous semester *Report*, the consumer portfolio of these financial institutions behaved differently depending on whether the financial institution was regulated or not. In the case of non-regulated entities, the increase in delinquency rates observed during last semester's *Report* stabilized, while delinquency rates of regulated entities' portfolios slightly increased. Given the challenges they continue to face, it is not possible to rule out the possibility of some of the sector's entities being affected. Therefore, it will be important to continue monitoring their situation, and their interconnections with the rest of the financial system.

This document analyzes four macro-financial risks for the financial system: i) tighter and more volatile global financial conditions due to a higher-than-anticipated increase in interest rates and in inflation in some advanced economies; ii) a recovery of the global economy with greater heterogeneity across sectors and countries in the medium term; iii) prolonged weakness in domestic demand; and iv) a downgrade of sovereign and Pemex credit ratings.

In addition to the risks described above, there are others related to financial institutions' operational continuity, which nevertheless could be declining given the reopening of both bank branches and Automatic Teller Machines (ATMs) as economic activity reactivates. As for Banco de México, the financial market and payment system infrastructures it manages and operates have maintained high levels of availability, with no incidents reported in both the technological infrastructure it uses for these purposes, and in its operating processes. Concerning cyber risks, although some continued to materialize during the period analyzed by this *Report*, they have not affected the financial institutions' clients, nor have they significantly affected its processes and resources, thanks to the continuing improvement in incident-response processes. Considering that the economic and financial impact associated with climate change may result in significant future losses for financial institutions and pose a risk for the financial system in general, this edition of the *Report* expands the analysis that Banco de México has been presenting on environmental risks and sustainable financial assets since 2018.

As in previous editions, this Report includes a stress testing exercise to assess the resilience and loss absorption capacity of Mexican banking institutions under extreme but plausible adverse scenarios. It is important to note that stress tests are not Banco de México's forecast of banks' potential losses. The stress tests consider three 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 results show that with the current banking institutions' capitalization indices in Mexico, the system reaches the simulation horizon above regulatory minimum levels, plus capital supplements, at an aggregate level and under the six considered scenarios. However, at the individual bank level, certain banking institutions, representing a low percentage of the system's total assets, could show capitalization levels below regulatory minimum levels in some of the simulated scenarios. Similarly, the aggregate banking institutions' leverage ratio would be, on average and in all simulated scenarios, above the regulatory minimum of 3%, although some institutions would end the exercise below this level.

More than a year after the beginning of the COVID-19 pandemic, the Mexican financial system shows resilience and is in a solid position to contribute to the economic recovery. Nevertheless, the risks associated with the evolution of the health contingency continue to be the most relevant for the financial system.

As the pandemic has evolved, Banco de México and other financial authorities have implemented or extended measures to continue promoting an orderly functioning of financial markets, strengthening credit channels, and supplying liquidity for the sound development of the financial system. It is worth noting that these measures have also contributed to reduce uncertainty and to channel resources to sectors affected by the pandemic. Banco de México

will continue to follow the evolution of financial markets in the country closely 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.


BANCO DE MÉXICO
www.banxico.org.mx