



BANCO DE MÉXICO®

# Financial Stability Report

Executive summary

December 2021

## Executive summary

During the period analyzed in this *Report*, the Mexican economy continued to be immersed in an economic and financial environment affected by the evolution of the pandemic and new variants of the virus. Although this has affected the conditions in which the Mexican financial system operates, it remains in a solid and resilient position, with banks' capital and liquidity levels comfortably meeting regulatory minima.

The outlook for the Mexican economy indicates that the reactivation of economic activity that took place during 2021 will continue through 2022, although at a more moderate pace, and it cannot be ruled out that some degree of uncertainty and heterogeneity in the performance across sectors will remain. Meanwhile, a commensurate recovery in lending has yet to be observed.

Global economic activity continued to recover during the second and third quarters of 2021, albeit at a slower rate and heterogeneously across countries. In this environment, forecasts for world economic growth were revised slightly downwards for 2021 and remained unchanged for 2022, although uncertainty has increased recently. Inflation has risen worldwide in 2021. This reflected imbalances between supply and demand, partly associated with bottlenecks in global supply chains, the reallocation of spending towards merchandise, pressures on food and energy prices, as well as the effects of the reopening and gradual normalization of the provision of some services.

In this context, international financial markets have overall performed positively during the period covered by this *Report*, although with certain bouts of volatility and risk aversion during September and from mid-November onwards. These developments have taken place in a situation of uncertainty as to the trajectory of the pandemic, which has intensified as a result of the emergence and detection of the new Omicron variant of the SARS-CoV-2 virus. Adding to the prevailing uncertainty is the increase in inflationary pressure which, albeit of a temporary nature, does not allow ruling out the effects of greater-than-previously anticipated persistence in price rises. This in turn complicates processing the

signals regarding a gradual withdrawal of monetary stimulus in some advanced economies. Thus, uncertainty regarding the future dynamics of financial markets persists.

Mexican financial markets have generally exhibited behavior consistent with that of international markets. More recently there has been an increase in volatility, associated with greater risk aversion and other idiosyncratic factors. All aggregate risk indicators are at lower levels than in the first half of 2020, when the pandemic first struck. Nevertheless, over the past few weeks, they have increased to levels above those registered during the first half of 2021. The Mexican Financial Markets Stress Index (*IEMF*, for its acronym in Spanish) followed a downward trend which started displaying some reversion in October due to pressures in both foreign exchange and debt markets. Meanwhile, the domestic Financial Conditions Index (*ICF*, for its acronym in Spanish) has trended upwards since July.

Looking ahead, risks associated with global financial conditions persist. Conditions could tighten due to uncertainty over the trajectory of interest rates in the United States, should realized inflation be higher and more persistent than previously expected. In such a situation, capital flows to emerging market economies, including Mexico, could be affected and firms' financing costs could increase.

In this context, although certain risk and vulnerability metrics which increased as a consequence of the health contingency have subsequently been fading, others remain at levels above those previously observed. However, in view of the resilience and generally solid position, characterized by capital and liquidity levels above regulatory minima, the broad Mexican financial system, and commercial banks in particular, are well-positioned to support the economic recovery.

Although mobility indices have returned to their pre-pandemic levels, apparently as a consequence of progress in the vaccination process and a gradual reactivation of economic activity in Mexico, some adverse effects of the pandemic on employment and households' income levels persist. Data points to a recovery, however these metrics are still at levels lower than those registered prior to the pandemic.

Total financing to households continued decreasing, a trend that has been observed for the past six quarters. This trend is driven by the unfavorable evolution of consumer credit. In contrast, mortgage loans continued to expand during the second and third quarters of 2021, although at a slower pace than during previous quarters. Total financing to non-financial private firms in Mexico continued declining, although at a slightly slower pace during the last quarter than in the previous two quarters. This contraction resulted from both lower domestic and external financing. Although the decrease in financing has affected all firms, it has been more evident for large firms. In turn, credit granted to small and medium-sized enterprises (SMEs) exhibited a relative improvement with respect to 2020, although it still remains below the levels registered in 2019.

With respect to the financial position of the public sector, during the period of January-September 2021, the public balance registered a lower deficit than what was projected in the 2021 Economic Package. As for state-owned productive enterprises, it is noteworthy that Pemex's financial position has improved slightly in recent months. This improvement resulted from increases in its revenues and operating cash flow following the rise in oil prices since early November 2020, as well as higher export volumes. A number of measures implemented by the federal government have also contributed, as it has made capital contributions to cover Pemex's debt payments during this period.

Regarding external financial flows, the financial account balance registered capital outflows during the second quarter of 2021 as a result of net lending to the rest of the world, and inflows due to net borrowing during the third quarter. As to portfolio flows, the latest information from the Institute of International Finance (IIF) shows that Mexico has continued to accumulate non-resident portfolio outflows since the outbreak of the pandemic. In other emerging market economies, the accumulated flows during this period are already at levels close to zero. Said behavior does not include China, a country that has been absorbing capital flows in recent months.

Commercial banks' capitalization levels increased between March and September 2021. This was mainly due to higher contributed capital, stemming

from the banks' positive financial results. The increase in capital was more than enough to compensate the increase of total risk-weighted assets during the period. Consequently, the financial system's Capital Adequacy Ratio (CAR) has continued to increase, putting banks in a solid position to face possible adverse scenarios. As to commercial banks' risks, those related to liquidity, market, credit and contagion have declined, or are at levels below those estimated at the outbreak of the pandemic. Nevertheless, it will be important to follow up on their evolution in the current environment.

Development banks and other development financial institutions remain financially sound, as reflected by the positive direction of their main balance sheet and financial statement items. Development banks are adequately capitalized and the sector's institutions have a Capital Adequacy Ratio (CAR) above regulatory capital requirements, although liquidity indicators are below their respective tolerance levels. The pandemic has had an impact via reduced lending and greater holdings of preventive reserves by these institutions.

As to risks to other financial intermediaries, throughout the pandemic some experienced an increase in delinquency rates on their loan portfolio and a fall in profitability. However, the recovery in economic activity has eased an improvement in financial indicators for some of these intermediaries. Since these institutions currently are relatively small and are not closely interconnected with the country's banks, they do not pose a risk to financial stability. Given the challenges they continue to face, the possibility of some of the sector's entities being negatively affected cannot be ruled out. Therefore, it will be important to continue monitoring their situation as well as their interconnections with the rest of the financial system.

This *Report* analyzes the following macro-financial risks to financial stability: i) tighter global financial conditions, due to faster-than-anticipated increases in interest rates in the major advanced economies, in response to greater and more persistent increases in inflation; ii) a less vigorous and more heterogeneous (across both sectors and countries) recovery of the global economy; iii) a prolonged and more accentuated weakness in domestic consumption and



investment; iv) potential increases in sovereign and Pemex's risk premium, as well as implications for their credit ratings.

In addition to the risks described above, there are others related to financial institutions' operational continuity. These operational risks could be decreasing at the margin, 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 either the technological infrastructure or in its operating processes. Concerning cyber risks, although some did materialize during the period analyzed by this *Report*, they have not affected financial institutions' clients, nor have they significantly affected financial institutions' processes and resources, thanks to the continued improvement in incident-response processes.

Considering that the economic and financial impact associated with climate change may lead to significant future losses for financial institutions and pose a risk to the financial system in general, this edition of the *Report* expands the analysis that, since 2018, Banco de México has been presenting on environmental risks and sustainable financial assets. In this regard, it is worth noting that the Central Bank is currently developing a framework to undertake scenario analysis, which explicitly considers the impact of physical risks and transition risks derived from climate change.

As in previous editions, this *Report* includes a stress testing exercise to assess the resilience and loss absorption capacity of Mexican banking institutions under extremely adverse, but plausible, scenarios. It is important to note that stress tests are not Banco de México's forecast of banks' potential losses. The stress tests consider four 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 Mexico's banking institutions' current capitalization index, for each of the seven considered scenarios, the system as a whole finishes the

simulation horizon with capital levels above regulatory minima (plus capital supplements). However, at the individual level, certain banking institutions, representing a low percentage of the system's total assets, could experience a greater negative impact on their capitalization 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%, but some institutions would end the exercise below this level.

Over 20 months since the outbreak of the pandemic, the Mexican financial system continues to show resilience, and has maintained a solid position with capital and liquidity levels comfortably meeting regulatory minima.

As stated in previous *Reports*, to address the effects of the COVID-19 pandemic on the financial system, Banco de México along with other financial authorities implemented and, when deemed necessary, extended, a series of economic measures. These sought to continue promoting the orderly behavior of financial markets, strengthening lending channels, and providing liquidity for the development of the financial system. It is worth noting that the majority of the implemented economic measures, which indeed did contribute to an orderly behavior of financial markets and intermediaries, expired during the second half of 2021.

Banco de México will continue to follow the evolution of financial markets in Mexico closely and will 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.



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