



BANCO DE MÉXICO

Financial Stability Report  
Executive Summary

December 2019



## Executive Summary

Since the publication of the previous *Financial Stability Report* in June, the prevailing environment has been characterized by significant uncertainty associated with both external and domestic factors. Nevertheless, Mexico's financial system has continued to grow at a moderate rate without excessive risk-taking. Thus, both the financial system and the banking system in particular, have maintained adequate solvency and liquidity ratios, with low-risk levels. Looking ahead, Banco de México will continue to monitor the financial system's performance, and any likely realization and evolution of vulnerabilities.

Consistent with the above, the aggregate risk indicators, such as the Financial Market Stress Index (FMSI) and the Mexican financial system heat map, suggest that, although both varied from June to date, their current levels are comparable to those observed at the beginning of the period. Thus, although the FMSI increased considerably in August due to volatility in the foreign exchange and stock markets, and to country risk, as of September, it has decreased. The second indicator points to a mild decline in Mexico's financial system's aggregate risk vis-à-vis the aggregate risk published in the previous edition of this *Report*.

As to Mexico's financial cycle, information available up to the third quarter suggests that it continued to slow down, maintaining the change in trend registered at the start of 2018. This deceleration indicates that risks for financial stability related to excessive credit growth are low. Households' financial positions overall continued improving due to an increase in their saving-to-borrowing ratio.

With respect to the financial position of the country's private non-financial companies, during the third quarter of 2019, the growth rate of total financing to these firms remained relatively stable vis-à-vis that registered during the first half of the year. It should be noted that it was observed a reduction in the growth rate of financing from almost all domestic sources (banking and non-banking), with a slowdown of commercial bank credit to large companies and a low dynamism in credit to Small and Medium Enterprises (SMEs), which continued to exhibit close to zero growth in annual real terms. During the third

quarter, financing from external sources also continued to contract, although at a considerably slower rate than observed in previous quarters. This trend is mainly explained by the loosening of financial conditions in advanced economies. Such conditions reduced funding costs, which enabled certain Mexican companies to issue debt abroad.

Regarding companies listed on the stock exchange, although they have faced some challenges due to slower economic growth, and uncertainty, their financial position in real terms has remained solid because of continued moderate levels of debt and debt service burdens.

In this environment, although the delinquency ratios of both households and private non-financial companies have remained relatively low and stable, if economic activity continues to exhibit lackluster growth or if employment diminishes and thus affects household's income—in particular, lower income ones, which in general register higher debt levels—the delinquency ratios of credit granted to these sectors may increase.

As to the public sector's financial position, at the end of the third quarter of 2019, the deficit was lower than the level budget for in the 2019 Economic Package. Although revenues were lower than the expected in the Economic Package, accumulated expenditures were even lower. With respect to State-owned companies, Pemex's financial situation remained under pressure. In this regard, it is worth highlighting that, since the publication of the previous *Financial Stability Report* in June, Pemex implemented several measures to limit its indebtedness and refinance its liabilities. In addition, the Federal Government announced a series of actions supporting the company's investment spending and curbing the fall in oil and gas production. Although the fulfillment of the established production and financial sustainability goals may contribute to consolidating Pemex's financial position, if this does not materialize, both the company's income and the public finances will be affected as well as the credit rating outlook of both Pemex and the Government's debt as well. Failing to achieve the established goals will lead to greater financing costs, negatively affecting both public and private issuers' access to financial markets, in addition to potentially deteriorating commercial

banks' credit portfolios and generating greater volatility in Mexican financial markets.

Regarding the aggregate financial position of the Mexican economy, as of the second quarter of 2019, the net international investment position continued to be negative and widened compared to the level of the same quarter of last year. In general, in an environment of greater global or domestic volatility, portfolios could be reallocated towards less risky assets, thus affecting capital flows. At the same time, capital outflows could impact the sources of financing, which would reduce the resources available for credit granting in the country.

Commercial banks are the main intermediaries of the financial system and have maintained high levels of capitalization and liquidity to deal with episodes of financial stress. During the second and the third quarters of 2019, risks assumed by banks remained low. Credit risk declined slightly, while market risk increased marginally. As for liquidity risk, all banks maintain adequate liquidity levels and comply with established regulations and international standards. The risk of interbank contagion has trended slightly downwards since May.

Development banks and other development financial institutions remain financially sound and prepared to face possible adverse scenarios and maintain adequate capitalization levels. The credit portfolios of these institutions have moderate levels of nonperforming loans while their market risk remains low. As for operational risk, some of these intermediaries must still address weaknesses related to information technology.

During the analyzed period, financing provided by other non-bank financial intermediaries to the Mexican economy continued to increase. Among such intermediaries were Savings and Loans' Cooperatives (*Sociedades Cooperativas de Ahorro y Préstamo*, SOCAPs), People's Finance Corporation (*Sociedades Financieras de Préstamo*, SOFIPOs), SOFOMEs (*Sociedades Financieras de Objeto Múltiple*), credit unions, financial entities, department store credit cards, and the sector known as FinTech companies. Although growth of these entities usually start from a relatively small base of assets and there are limited risks of contagion, it will be relevant from the point of view of financial

stability, to monitor the interconnections that they maintain with other entities in the financial system.

Given that the Mexican economy is still facing a complex environment, this edition of the *Report* focuses particularly on four macro-financial risks to the financial system: i) the significant slowdown of global economic growth, ii) the adoption of greater protectionist measures worldwide and growing geopolitical risks, iii) volatility in international financial markets with a reallocation of flows towards less risky assets, and, iv) lower investment and growth in the Mexican economy.

This *Report* also analyzes cyber threats and IT-related risks. Such risks are among the most relevant ones that the financial system faces due to the increasing importance of IT technologies for its operation, which has increased the potential scope of attacks.

The analysis of the risks imposed by climate change on financial system participants is also addressed. Climate and environmental risks can constitute a major source of losses for the financial system and, in extreme cases, could have systemic consequences.

As in previous editions, this *Report* includes stress test results. The purpose of this exercise is to assess the resilience of the banking system in the event of significant and extreme macroeconomic and financial shocks, which, although of low probability, are possible. Five sets of stress scenarios are analyzed, four of which are related to the aforementioned macro-financial risks and a fifth corresponds to historical extremely adverse scenarios, which reflect the financial system's reaction to shocks qualitatively similar to stress periods the Mexican economy has experienced in the past. In all the scenarios analyzed, the system's Capital Adequacy Ratio (CAR) remained above the minimum regulatory level plus additional capital requirements, suggesting that the banking system is in a solid position to face adverse events. Nevertheless, as pointed out in previous editions of this *Report*, the stress scenarios could become more complicated or intensify depending on the interaction and feedback effects between the different vulnerabilities.

In this environment, the Mexican authorities have continued their efforts towards implementing macroprudential regulation, in line with international standards and best practices. This effort responds to

the goal of strengthening the regulatory framework and, in this way, reducing the risks to the financial system.

To conclude, it is worth emphasizing the importance of preserving a stable, efficient, and innovative financial system that can face the complex environment analyzed in this *Report*, without implying that financial intermediaries take more risks, and without compromising the adequate functioning of the financial system. The current environment is characterized by significant

uncertainty associated with both external and domestic factors. A financial system with these features enables financial institutions to safely and efficiently intermediate the public's savings towards profitable projects. However, it also requires a solid institutional framework, adequate human capital, and financial regulation and supervision that safeguard the integrity of the system and protect the public's interests. In this way, the financial system can contribute to sustainably increasing both economic growth and the population's well-being.



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