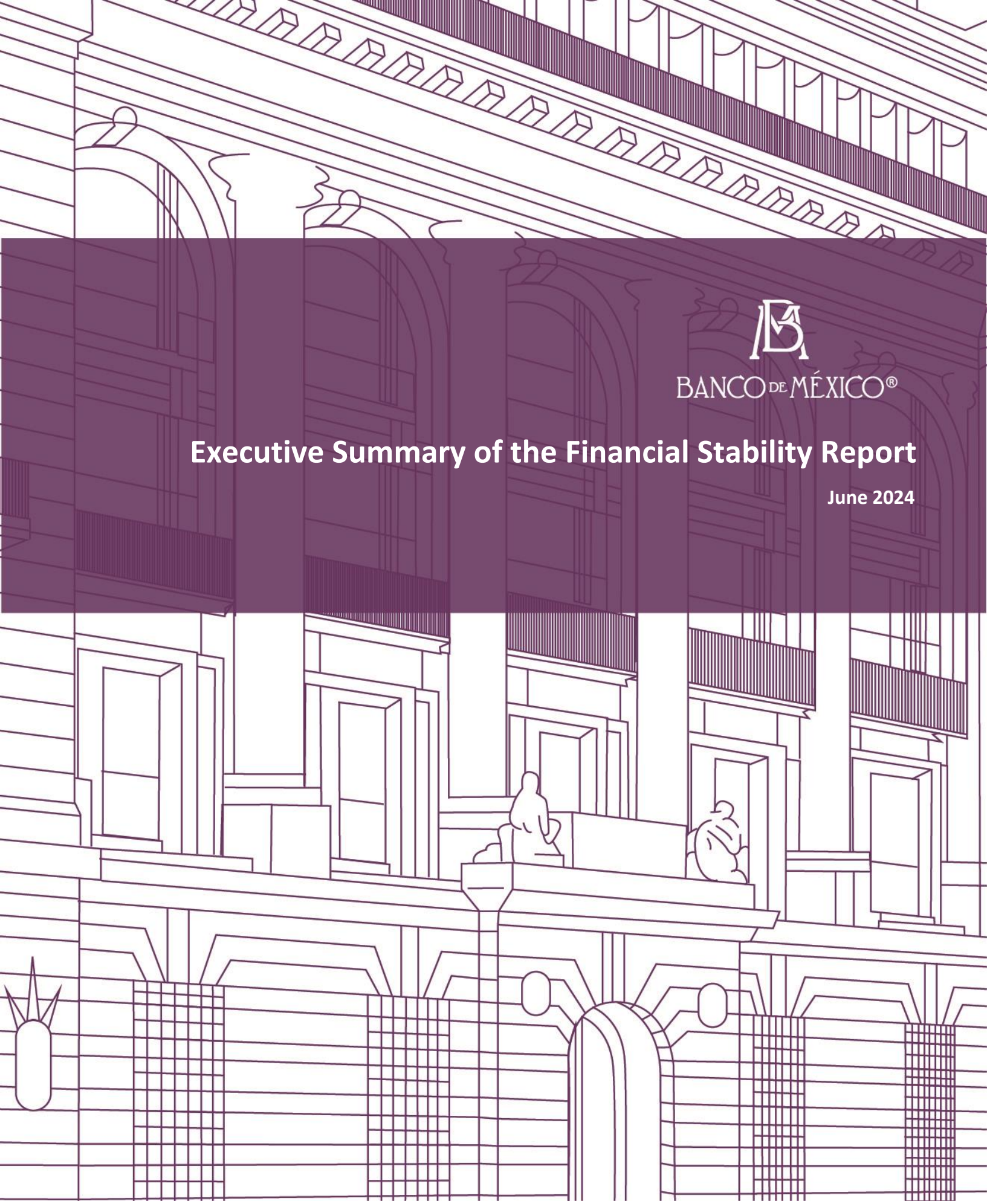


BANCO DE MÉXICO®

Executive Summary of the Financial Stability Report

June 2024

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Executive summary

During the period covered by this *Report*, the Mexican financial system maintained a solid and resilient position. This was despite an environment in which global financial conditions remained relatively stable during the period, as they tightened in April. Moreover, given that in major developed and some emerging economies, inflation continues to show persistence and remains above central banks' targets.

International financial markets exhibited periods of volatility due to greater risk aversion amid the intensification of geopolitical conflicts in the Middle East. This has negatively affected the performance of some financial assets in emerging economies.

In its most recent outlook, the International Monetary Fund (IMF) revised its global economic growth forecasts for 2024 slightly upwards and left those for 2025 unchanged. Regarding economic activity in Mexico, the latest data indicate that Mexico's GDP continued slowing in the first quarter of 2024 continuing the slowdown that began in the fourth quarter of 2023.

Regarding the monitoring of Mexico's financial system carried out in this *Report*, data on the evolution of the main risks to financial stability are highlighted, as their materialization could affect the proper functioning of the economy.

The analyzed risks are divided into two main categories. The first set comprises possible macrofinancial risks, which consist of risks that could result from the deterioration of financial and macroeconomic variables, both domestically and internationally. The second category addresses the risks that affect the main segments participating in the financial system: specifically, households, firms, the public sector, the banking sector, and the non-bank financial sector. This analysis also includes disruptions and risks that may arise in financial markets and payment systems.

Regarding the category of macro-financial risks, four main risks are identified that, if realized, could affect the stability of the Mexican financial system: i) tighter financial conditions for a longer period than previously anticipated; ii) downward pressures on economic activity and a more volatile market environment due to heightened geopolitical tensions and/or trade conflicts; iii) a systemic event that affects the global financial system; and iv) unexpected adjustments of credit ratings for either the Mexican government or Pemex.

The analysis of risks pertaining to the second category is based on a series of quantitative and qualitative indicators. Aggregate risk indicators, as the Financial Conditions Index (ICF, for its acronym in Spanish), shows that aggregate financial conditions in Mexico remained restrictive, although less than in the previous *Report.* Additionally, the Mexican Financial Markets Stress Index (IEMF, for its acronym in Spanish) decreased from December 2023 to May of this year, although it rose slightly in April, mainly due to the escalation of geopolitical conflicts. At the beginning of June, the IEMF increased again due to the performance of the domestic foreign exchange, debt and equity markets. This index thus ended above the level recorded in the previous *Report.* On the other hand, overall risk in the financial system, as illustrated by the heat map, remained at a similar level to that observed in the previous *Report*. Taken together, the above indicators suggest that the aggregate risk of the Mexican financial system, under the expected trajectory and in the absence of shocks, remains contained. Banco de México continues to monitor its evolution.

During the first quarter of 2024, total financing to the Mexican economy increased in real annual terms and, as a share of GDP, it remains at levels similar to those observed in 2015. However, the financing gap has registered negative values in twelve consecutive quarters.

Data as of the end of March 2024, show households' financial positions increased in comparison to the level presented in the previous *Report*. While household leverage, measured as the ratio of monthly income available to pay down debt, generally remained at levels similar to those of last year, with higher leverage observed for lower-income borrowers. Consumer credit granted by commercial banks and their related sofomes continued increasing. In addition, non-performing rates of consumer loans granted by commercial banks began declining in 2024, in all segments, except for

automotive loans. Furthermore, risks associated with consumers remain limited as newly granted credits for most types of loans, show stable regulatory default probabilities. Total housing financing grew at a slightly higher annual real rate compared to the previous *Report*, with the Infonavit housing portfolio registering positive growth for the first time in two years. Additionally, banks' non-performing loans in this segment are at historical lows.

With respect to non-financial private firms, their total financing decreased slightly in real annual terms, albeit at a slower pace compared to the previous *Report*. Regarding domestic financing, credit granted by commercial banks remain the most relevant source of credit and, this showed positive growth. In contrast, external financing to this sector has contracted for fourteen consecutive quarters, due to a decline in both foreign bank credit and in international corporate debt issuance. The non-performing loan ratio for the portfolio of credit granted by commercial banks to firms, started to decline as of November 2023, driven by large companies. Additionally, the non-performing ratio for loans granted by non-bank financial intermediaries in the regulated and non-regulated sectors, decreased compared to the last *Report*. The Listed Companies Vulnerability Index (IVEL, for its acronym in Spanish), which measures the vulnerability of publicly listed companies as a group and by economic sector, increased as compared to the previous *Report*. However, the IVEL remained in the low vulnerability zone. And, the exposure of Mexican banks to private non-financial listed companies with some vulnerability, remains low relative to banks' regulatory capital.

Regarding the public sector's financial position, at the end of 2023, the federal public balance registered a deficit lower than projected in the government's Economic Package for that year. However, the Public Sector Financial Requirements (RFSP) were 4.3% of GDP. Then from January to March 2024, the public sector balance had a larger deficit than anticipated, and the RFSP are expected to reach 5.9% of GDP by the end of 2024, with the fiscal deficit reaching 50.2% of GDP. On the other hand, the debt levels of state and municipal governments, according to the warning system indicators of the Ministry of Finance (SHCP, for its acronym in Spanish), remain at sustainable levels.

Regarding the external sector, based on data from the balance of payments, capital inflows were strong in the first quarter of 2024. Notably, portfolio flows from non-residents continued consolidating the recovery exhibited since the last *Report*, with strong inflows in December 2023 and March 2024. However, our own estimates suggest that there is still a substantial margin for these flows to continue recovering.

Regarding the banking sector, this is the largest in terms of financial assets, and continues to show abundant liquidity and capital, well above the regulatory minima. These capital levels allow banks to have the capacity to absorb shocks or manage unexpected events that could materialize in the short and medium term. Also, the analysis of banking sector vulnerabilities shows that these remain limited. Credit risk remained at relatively stable levels during the period covered by this *Report*. Looking ahead, its evolution is expected to continue to be determined by the performance of economic activity in the country. As for market risk, it decreased slightly with respect to the last *Report*, because of adjustments in portfolio positions, particularly in instruments sensitive to interest rate movements.

Commercial banks as a whole are resilient based on the results of solvency and liquidity stress tests that assume adverse but plausible scenarios that institutions could face. The main objectives of the analyses are: i) to identify and analyze vulnerabilities of the banking system as a whole, ii) to evaluate the resilience and loss absorption capacity of Mexican banking institutions in the designed scenarios; and iii) to evaluate the liquidity position of commercial banks if faced with stress episodes similar to those experienced in the past, as well as to estimate cash outflows that could take place under certain severe scenarios.

The results of the credit stress tests show that the capitalization ratio of Mexican banking institutions would allow the financial system, in the scenarios considered, to conclude the three-year simulation horizon at capitalization levels well above the 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 could experience a greater impact on their capitalization levels in some of the simulated scenarios. In liquidity stress tests, the results show that banks, overall, could manage high stress episodes and that banks as a whole would maintain a liquidity surplus.

Development banks and other development financial institutions, remain financially sound, both in their capitalization and liquidity levels. Despite reducing their credit exposures and registering a real annual decline in loan loss reserves, both the main items of the balance sheet and income statement have evolved favorably for this group of institutions.

The regulated and non-regulated non-bank financial intermediaries' sector (OIFNB, for its acronym in Spanish) showed a slight recovery in its funding and market financing conditions at the end of 2023 and beginning of 2024. These institutions are vulnerable to a downturn in economic activity for the population segment and the firms they cater for, and therefore an abrupt slowdown could lead to a significant deterioration in non-performing rates and thus threaten their credit rating and hamper generation of net interest margin income. These institutions do not represent a risk to financial stability since they are small and have few interconnections within the country's banking system.

In addition to the aforementioned risks, the *Report* also monitors business continuity risks of financial institutions, as well as the performance of financial market infrastructure and payment systems managed and operated by Banco de México due to their systemic importance. At the end of April 2024, the operability levels of financial markets and payment systems' infrastructure remained high and payment systems did not experience any interruption in their services as a result of an incident.

Cyber risk remains one of the major risks for the global financial system. In particular, cyber risks to the stability of the financial system associated with the growth in the use and sophistication of Artificial Intelligence (AI) stand out. In this regard, Banco de México monitors and is incorporating into its institutional risk management the risks associated with AI that, due to their nature, call for specialized attention. The indicators developed by Banco de México to measure cybersecurity levels in the Mexican financial system indicate that cybersecurity is adequate.

In addition, Banco de México monitors climate-related risk by analyzing banks' corporate, mortgage and consumer loan portfolios exposure to potential losses that could arise from the materialization of hydro-meteorological phenomena. The objective is to encourage financial system participants to internalize the economic and financial impact associated with physical risks due to climate change, as it could represent a risk to the stability of the system as a whole. The analysis identifies banks whose loan portfolios are not well diversified because they are simultaneously exposed to climate-related problems caused by heat waves, droughts, and tropical cyclones. These banks have a greater vulnerability to liquidity risk shocks.

This *Report* also presents the results of stress tests for physical risks associated with climate change. This simulation exercise evaluates the resilience of the banking system to the occurrence of extreme hydro-meteorological events. The most severe hurricanes observed in recent years, with similar economic effects are used to identify the magnitude of the impact on the capital adequacy ratio. The results show that although the impact on capitalization is not insignificant, it does not represent a risk to the banking system's solvency. This exercise also identifies additional losses that could arise in the event of simultaneous macro-financial and climate-related shocks.

Regarding the monitoring of the evolution of sustainable financial assets, in the first three months of 2024, the issuance of thematic bonds by domestic private and public issuers was higher than in the same period of 2023. Finally, as part of its efforts to contribute to the continuous improvement of the regulatory framework, in order to keep it robust and updated as well as to promote the adoption of best practices and international standards, during the period covered by this *Report*, Banco de México implemented measures related to repurchase agreements, derivative transactions, reference rates, liquidity provision to commercial banks, sustainable financial assets, and facilities for borrowers affected by Hurricane Otis. Looking ahead, it will monitor the

evolution of risks and vulnerabilities that could negatively impact financial stability, in order to implement actions to mitigate them and preserve both the stability of the financial system and the proper functioning of payment systems. The above will be done, according to its constitutional and legal authority, in strict compliance with the legal framework, and in coordination with other financial authorities.



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