banco central Chile

FINANCIAL STABILITY REPORT

FIRST HALF 2024

SUMMARY

The external scenario continues to be the main source of risks for local financial stability. In a context where global financial conditions remain tight, uncertainty persists about the onset and speed of the monetary tightening cycle in the US, which has affected short-term market rates and may generate abrupt corrections on the high valuation of some financial assets. Additionally, long-term rates remain at high levels and the risks surrounding sovereign debt are relevant globally. The gap between the economic cycles of emerging and developed economies, the high levels of debt and the vulnerabilities in segments of the credit markets can further tighten financial conditions for emerging economies. Global geopolitical tensions remain high and their potential effects on inflation contribute to increasing uncertainty regarding the course of monetary policy in advanced economies. Internally, the economy has resolved the significant macroeconomic imbalances of previous years, although the depth of the capital market remains low. The reduction in inflation and short-term interest rates has contributed to normalizing indebtedness and the financial burden of households and firms, in a context of credit activity in line with the evolution of the economic cycle. The economy is recovering; however some sectors show a lag, which has raised delinquencies to high levels in historical perspective. The banks have managed these developments adequately and preventively, accumulating relevant levels of provisions. Together with appropriate levels of liquidity and capital, this permits banks to adequately withstand stress scenarios. However, banks must continue to prepare for the upcoming challenges they face, associated with the convergence towards Basel III standards. Finally, the external macrofinancial situation highlights the importance of continuing to strengthen the resilience of local agents and the financial market.

SITUATION OF THE FINANCIAL SYSTEM

At a global level, uncertainty persists about the onset and speed of the monetary tightening cycle in the US, which has affected short-term market rates in that economy and may generate abrupt corrections in the high valuations of financial assets. Long-term interest rates in developed economies are high in historical perspective. This has permeated to the local economy, where rates on longer-term mortgage and commercial loans have also remained at high levels. In contrast, short rates have decreased in line with the MPR cuts in Chile. This has alleviated the financial situation of firms and households. However, a significant increase in delinquency rates is observed in sectors that are further behind in their recovery, banks have adequate levels of provisions and capital to face scenarios of greater deterioration.

The Federal Reserve (Fed) has adopted a more cautious tone and the markets have postponed the date in which they estimate the cuts in the Fed Funds Rate (FFR) would begin. In the US, since the beginning of the year, the persistence of services inflation, together with positive private consumption figures and a labor market that remains tight, have raised concerns about its inflationary convergence. This has led to upward corrections on growth forecasts for the current year, with market expectations indicating that the first FFR cut would occur towards the latter part of the year, later than anticipated in the previous Report.

Long-term interest rates have risen in the US and other developed countries, a development that has passed through to emerging economies, including Chile. The US ten-year term rate stands at 4.6%, 230bp above the average of the last decade. For the average of emerging economies, the ten-year rate reaches 8.5%, while for developed economies it is at 3.8%, which compares with 6.7% and 1.9% for the last decade, respectively. In particular, the rise in long rates in the US has occurred in an environment of greater concern about the fiscal situation in that country. Added to the above are the prospects for greater spending in advanced economies due to, among others, greater demand for resources associated with climate change and geopolitical conflicts. The future evolution of long-term rates also depends on structural factors such as demographic changes and global savings patterns, which contribute to greater uncertainty about interest rates levels in the coming years (BCCh ND N°1).

The valuation of some financial assets remains high globally. In line with a better economic outlook, positive firms' results and a greater appetite for risk, stock markets in most economies continued to show improved performance in recent months. Besides, corporate spreads have decreased in advanced economies and volatility indicators remain around the average level of last year. However, episodes of reversal have been observed, which reflect a high sensitivity of financial markets to negative news, such as what occurred in mid-April due to increased geopolitical tensions.

At the local level, the economy resolved the significant imbalances accumulated in previous years. Inflation had a rapid decline from the 2022 highs and is at levels close to the 3% target. Domestic spending has declined, the current account deficit decreased, and the output gap has narrowed. Indicators of local stress and uncertainty are around pre-pandemic levels, while the volatility of interest rates is below the level observed in a group of comparable economies.

Short-term interest rates have dropped, reflecting the cuts in the Monetary Policy Rate (MPR). From July 2023 to date, the MPR has been reduced by 475bp, which have passed through on to short-term interest rates, such as commercial and consumer loans, which have fallen 420 and 340bp, respectively.

However, local long-term interest rates have remained high in historical perspective, reflecting the external scenario. As of the closing of this Report, the BCP10 rate was around 6%; this higher level of the base rate—together with an increase in spreads—has been passed on to the cost of long-term local corporate financing. Spreads for firms showed slight increases in the last six months, which keeps longer-term rates high in historical perspective, while bond issuance continues low. In turn, local banks have issued bonds at shorter terms and with spreads above what was observed in the previous Report. Likewise, financing spreads for some Non-Bank Lenders have also increased.

Higher long-term rates have also affected the cost of mortgage loans, in a context where the dynamism of the residential real estate sector has remained low for several quarters. The vulnerabilities identified in previous Reports are still present in this sector. The available for sale stock of finished residential units has continued to increase, rental profitability has fallen, and higher vacancy has been observed. In this environment, delinquency of firms in the sector has increased and their access to credit has been restricted. This has been partially mitigated by a lower financial burden, due to lower short-term interest rates.

Financial market depth indicators have not recovered and remain below their pre-pandemic levels. A shallower capital market affects medium and long-term financing conditions and has less capacity to mitigate external shocks that the economy may face (FSR, first half 2022). Likewise, the high stock of local public and private debt due in the future may exert greater upward pressure on financing rates and spreads given the lower demand for local financial assets.

The background information presented in the latest Public Finance Report indicates that public debt would continue at around 41% of GDP in the coming years. However, the Autonomous Fiscal Council (CFA, April) has highlighted a series of risks that could affect this trajectory, which is particularly important to consider in a scenario in which long-term rates remain high for a long time. Maintaining prudence in fiscal accounts is essential for the economy to have external financing available without significant increases in its cost.

The aggregate debt of non-financial firms increased at the end of 2023, reaching 114% of GDP, mainly due to the increase in Foreign Direct Investment (FDI) and the valuation effect derived from the peso depreciation. This contrasts with lending activity and bond issuance that remain low. Large firms –which report their financial statements to the Financial Market Commission (CMF)– reduced their profitability, reaching levels close to their average for the last twenty years. Likewise, they show leverage, liquidity and interest coverage ratios close to their historical averages, without relevant currency mismatches.

In the case of firms that are financed by local banks, financial indicators showed a slight improvement, although some groups remain behind in their recovery. Sales are at higher levels and operating margins have recovered. Debt service ratios are lower, because of reduced short-term interest rates. However, certain groups identified in previous Reports are lagging in their recovery, such as smaller firms, those that obtained Fogape-Covid loans and the Retail, Construction and Real Estate sectors, which has led to increases in their delinquency rates.

The financial situation of households has also been stabilizing, in a context of increased income and reduced financial burden, due to lower interest rates on short-term loans. Aggregate household debt remained stable. In the mortgage market, credit growth remains low, while in consumer loans there are no new increases in the use of revolving debt. The latter type of debt, due to its shorter term and higher relative cost than other consumer loans, is more exposed to changes in interest rates. In turn, household financial indicators, such as debt service ratios, have continued to improve. According to the Bank Credit Survey, credit supply conditions for households did not show significant changes in the first quarter of the year, remaining restrictive, while demand heightened its weakening.

Credit activity remains in line with the local macroeconomic cycle. Mortgage loans maintained positive growth rates, while consumer loans, granted by both banks and non-banks, showed low activity. Commercial loans continue to show negative growth rates, which are mainly linked to demand factors. Indeed, the Bank Credit Survey for the first quarter indicates that demand for funding is weaker compared to the previous quarter, mainly due to lower investment. Supply conditions are perceived to be similar to those of the previous quarter.

In the banking sector, delinquency rates have increased, reaching high levels in historical perspective. For commercial loans, this increase continues to be explained mainly by firms that received Fogape loans during the pandemic, smaller firms and those in Retail, Construction and Real Estate sectors. Among households, arrears have also increased, reaching highs in the last decade for consumer loans, while mortgage delinquencies although growing, continue at relatively low levels. Likewise, consumer loan delinquency also remained high in non-bank providers.

The increase in credit risk indicators finds banks with adequate levels of provisions and increased guarantees. Banks' profitability continues its adjustment process toward pre-pandemic levels, with lower inflation margins and interest margins that have tended to recover, in a context where banks have been adjusting their funding structure toward lower duration. However, they maintain adequate liquidity levels after the first expiration of support policies deployed during the pandemic. Banks have made progress in adapting their capital levels in accordance with the greater regulatory requirements in the process of convergence towards Basel III.

FINANCIAL REGULATION DEVELOPMENTS

At a global level, after the events of March 2023 in international banking, initiatives aimed at strengthening banking supervision are beginning to materialize. The Basel Committee on Banking Supervision incorporated adjustments to its principles of prudential regulation and banking supervision, including the framework applicable to globally systemically important banks (G-SIB). Meanwhile, the US is in the process of leveling the regulatory framework applicable to banks according to their size.

At the local level, relevant progress has been made in the financial policy agenda, through initiatives in the areas of prudential regulation and payment systems. Various initiatives promoted by the Central Bank were completed, such as exchange rate framework modernization, the implementation of two new infrastructures for low-value payments and operations in foreign currency, and the setting of new investment limits in alternative assets for Pension and Unemployment Funds. Regarding banking prudential regulation, the convergence to Basel III standards continues, and the application of Pillar 2 capital charges due to the supervisory process by CMF. The implementation of the FinTech and Resilience laws in the financial system is also advancing, the Framework Law on Cybersecurity and Critical Information Infrastructure was published, modifications to the Law on fraud in payment methods were approved and relevant progress was made in the bill of Consolidated Debt.

MAIN RISKS

The external scenario continues to be the main source of risks for local financial stability. Financial conditions for emerging countries may register a significant tightening if external interest rates remain around current levels for a prolonged period or increase further. Internally, the materialization of this type of scenario could cause debtors' payment capacity to worsen beyond what is anticipated. However, banks appear resilient under the stress test scenarios.

The main risk is an increase in risk aversion and an abrupt price correction in financial markets. Given the high valuations of asset prices, various factors could trigger abrupt adjustments in their prices. First, a delay in the start of FFR cuts cannot be ruled out. Added to this is an additional deterioration – or prolongation – of the global geopolitical situation and its effects on the monetary policy of developed economies. If this scenario materializes, it could trigger an abrupt correction in the asset prices and would increase funding spreads for emerging economies. In addition, capital outflows from emerging markets would intensify and the dollar would strengthen globally. The Chilean economy would be affected by an increase in the cost of external financing and an exchange rate depreciation. However, the effects of the latter would be limited by the reduced currency mismatches in the balance sheets of both firms and banks.

Financial conditions for emerging markets would become restrictive if a scenario of high long rates for a prolonged period is consolidated. Fiscal spending pressures in developed economies and other factors mentioned above could translate into a permanent rise in long-term rates. This higher financing cost would make it difficult to renew sovereign debt and would increase risk premiums, affecting those economies with higher levels of debt to a greater extent. This increase in base rates would generally reduce the payment capacity of debtors, which could strain the balance sheets of banks globally. After a prolonged period of low interest rates, it is possible that vulnerabilities have accumulated due to excessive risk-taking in search of greater profitability. This could generate tensions in various segments of international financial markets, such as Non-banking Financial Institutions with greater leverage, exposed to illiquid assets and highly interconnected with the financial system.

To the vulnerabilities already identified in previous FSRs regarding US regional banking and the Chinese economy, there is added concern for the non-residential real estate sector in advanced countries. The latter has expanded to some European countries exposed to the North American market and has intensified in the face of the high rates scenario. Even if these risks appear to be contained, it cannot be ruled out that they could give rise to new episodes of mistrust – such as those seen in March of last year – with the risk of widespread contagion. In China, financial risks persist, due to the weakness of its real estate sector and high levels of debt. All of the above in a context of global sovereign debt that remains high in historical perspective.

In face of the materialization of an external risk scenario that significantly tightens financing conditions, it is possible that the deterioration in payment capacity of credit users at the local level could deepen. A prolongation of the scenario of high long rates that could slow down the recovery of the real estate sector would intensify the weakened situation of firms in that sector. Tighter external conditions would deteriorate activity, employment and household income, with a greater impact on the more vulnerable households and firms in more procyclical sectors, such as Retail.

Bank stress exercises show that local banks remain resilient. The results show that the system remains with adequate levels of liquidity, provisions and capital to remain solvent in the face of severe stress scenarios. However, as the Basel III implementation process continues, it will face higher capital requirements, so it will need to continue strengthening its capital base.

The external macrofinancial situation highlights the importance of continuing to increase the resilience of local agents and the financial system. The uncertainty regarding the control of inflation and its effects on monetary policy in the US, together with other sources of risk, such as geopolitical conflicts and the fiscal situation in advanced economies, suggest that financial conditions could remain tight for a prolonged time. At the local level, the resolution of significant macroeconomic imbalances has allowed the financial position of local agents to improve, such as household savings and the balance of external accounts, although certain sectors remain behind. Capital market depth remain at low levels, which in turn has reduced the economy's ability to cushion external shocks. Thus, it is necessary to continue strengthening the resilience of the financial market with the objective of facing an uncertain international context and possible adverse shocks, without putting financial stability at risk.

The Board has decided to maintain the CCyB at 0.5% of risk-weighted assets (RWA), which will be due from the end of this month. This level is maintained as a precautionary measure in the face of external uncertainty and a balance of risks similar to that of the previous IEF. This contains the possibility of an extreme negative event, which would imply a significant decrease in credit. Having a previously established capital buffer, which can be released when an event of this nature occurs, would help mitigate impact on the provision of credit to households and firms.

As announced in the previous FSR, during this year the Board has been reviewing the CCyB implementation framework, including the definition of its neutral level.

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