2009
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Financial Stability Report

BANCO CENTRAL DE CHILE

Summary*

The second half of the year continued along the trend toward better real and financial conditions that began last March. The resolute policy actions in the financial front, that provided both liquidity and guarantees, allowed for the gradual recovery of confidence. This reduction in uncertainty, together with expansionary macroeconomic policies, has resulted in signs of a recovering world economy.

Improved financial conditions, meanwhile, have translated into a decline in risk premiums, stock prices picking up and a resumption of portfolio flows to emerging economies. The Libor-OIS premium, that has served as a barometer to gauge the willingness of banks to both trust counterparties and let go of their liquidity, has returned to levels approaching those of August 2007. Risk premiums in other markets, such as U.S. corporate bonds with and without investment grade, the EMBI and the one reflected by financial institutions' CDS, have also declined to later stabilize in recent month at higher than pre-crisis levels. This is sound, considering that pre-crisis levels were abnormally low and partly reflected the conditions that incubated the crisis. Finally, stocks have recovered in both developed and emerging economies. The latter have received a significant inflow of portfolio investment.

However, in other dimensions, the situation of the international financial system still faces challenges regarding the recovery's consolidation. On one hand, international banks have yet to recognize losses originating in those assets that were directly affected by the crisis. This means that banking recapitalization of a magnitude that provides security and permits to resume credit market activity is a major challenge. On the other hand, lending is low in the countries that have been hit hardest by the financial meltdown. Credit weakness does not affect only bank loans, but also non-banking intermediation, which was severely affected by the crisis, particularly in the U.S., and has still not recovered.

The future trajectory of the financial system is not free of risks. One risk has to do with the fact that part of the relative stability achieved recently relies on specific financial system back-up programs, such as the possibility of issuing collateralized debt in the prevailing monetary policy conditions that have granted access to liquidity at a very low cost. This has permitted to generate profits that strengthen the banks' balance sheets. These policies are transitory and their withdrawal is set to occur in a gradual manner, beginning in the months to come. Meanwhile, the credit risk in certain assets—where worth singling out is the commercial mortgage portfolio—at U.S. and European banks, is still high. The recent default in Dubai is one example of such a risk materialized.

*/ This is a translation of a document originally written in Spanish. In case of discrepancy or difference in interpretation the Spanish original prevails. Both versions are available at www.bcentral.cl.

The recovery of the global financial system has been visible in improved access of the Chilean economy to international credit. Premiums charged Chilean banks above external reference interest rates, first declined and have now stabilized around 50 basis points. The dispersion of these premiums is higher than it was before the crisis, which apparently signals increased discrimination on the part of suppliers. This sets the right incentives to potential borrowers, as it rewards those with a stronger financial position. New counterparties have also emerged. However, other signs of tighter constraints remain, such as shorter lending maturities. Finally, Chilean firms have placed bonds in the international market, which, in practice, was closed for domestic firms since mid 2008.

The same as other emerging economies, Chile received significant portfolio investment inflows, which at the third quarter stood at 0.9% of GDP. **Chile stands out in portfolio investment outflows from institutional investors,** which have been particularly high, in both the second and the third quarter of 2009, getting as high as 3% of GDP.

Despite increased external borrowing seen since March, and a reduction in Chilean sovereign funds since the last Report, **different external liquidity indicators for the Chilean economy are showing improvement since the first quarter** and are at their best since December 2007. Additionally, the economy enjoys a strong position of aggregate external solvency.

In the local financial markets, it is worth noting the impact of the Central Bank of Chile's monetary policy actions, namely the reduction in the monetary policy interest rate and the establishment of the Term Liquidity Facility (FLAP) in July. After these policy measures, there was a marked flattening of the interest rate curve up to the maximum term of such facility. The spread between the prime rate and the interbank interest rate swap, both at 180 days, declined to almost zero and remained low through September, when market expectations began including a scenario of increased rates toward the end of the projection horizon. The use of the FLAP has been intense. At the closing of this Report, it had provided nearly C$2.5 trillion, of which $1.3 trillion had been drained through the deposit facility of the Central Bank. On 12 November, the Bank communicated that it would gradually reduce the term of the FLAP, until it fades completely in May 2010.

A second noteworthy development in the local financial market has been the substantial shift of portfolio of pension funds, mainly toward external assets. These assets went from 24% of the fund in February 2009 to 41.6% in October, with monthly average capital outflows of US$1.6 billion between March and September. Forward hedging contracts subscribed in foreign currencies reached, at the same time, US$1.4 billion per month. This has resulted in increases in the on-shore interest rate in dollars since September, which reflects, in turn, marginal interest rates for external funding that are higher than they were before the crisis. The prices of important domestic financial assets (e.g., stock indexes and the exchange rate) have adjusted significantly, but with moderate volatility.

In the second half of 2008, the Central Bank adopted various transitory measures to increase the flexibility of the financial market's liquidity operation in both pesos and foreign currencies, with the purpose of mitigating the effects of the global financial crisis on the local economy. Said measures permitted to opportunely prevent liquidity problems. **Due to the improved global financial scenario, the strong domestic financial system and the**

adequate access to international financial markets, the Central Bank of Chile announced last 30 October a program to withdraw the liquidity back-up measures.

During the second half, corporate bond spreads in the local market have returned to their historic averages. Meanwhile, **the strong dynamism of issued local market instruments has continued,** including bonds and commercial papers, which have become a borrowing option alternative to foreign credit. The dynamism of bond issuance is expected to continue in the coming months.

Within the group of companies with public balance sheets, those with a tighter liquidity situation at December 2008 are showing significant improvement at June 2009. Meanwhile, estimated currency mismatches are close to zero, one of the lowest figures of the decade.

At the third quarter of 2009, household debt shows a slight rebound in its y-o-y growth rates, particularly in its consumption component. However, **the ratio of total debt to disposable income (DIR) has dropped in the last two quarters, as has the ratio between the financial burden (principal and interests payable) and disposable income (FIR).** The drop in the FIR obeys to both the reduced contracted amount and lower interest rates prevailing. These adjustments are welcome from a financial stability perspective, given the higher risk faced by households of losing their jobs during the year. While the latest figures suggest that job losses have ceased, the recovery of employment normally takes one or two quarters to catch up with economic activity, so both households and lenders should continue to be particularly prudent for some time.

Despite the fiscal deficit projected for 2009, the government enjoys a solid financial position, reflected in a net creditor position of 17% of GDP.

Banking loans' y-o-y growth rates dropped to their record low in the third quarter of 2009, but are showing a slight rebound in recent months for every credit category. Growth in consumer and retail credit is close to zero, but mortgage loans continue to grow over 5%. Banks' performance has been fairly homogenous, with the exception of state-owned BancoEstado, whose commercial loans outperformed those of private banks. The banks' credit conditions survey confirms this increased dynamism, showing a growing fraction of banks responding that their credit conditions are more flexible than in the previous quarter, while sensing a stronger demand.

Late last year, the banks' portfolio risk indicators (i.e., stock and expenditure in provisions, past-due loans and write-offs) deteriorated sharply, in line with the real economy. Said deterioration proceeded until few months ago, and has been stable since. The hardest hit segments were mortgage and consumer loans.

Existing provisions for commercial and consumer loans exceed past-due loans. This is true, even using measures for past due loans that consider the totality of the bad loan and not only the expired installments. For housing loans—where collateral is greater—, provisions are the equivalent of 20% of the past-due portfolio, so that is the loss that could be faced in the average recovery value of collaterals (properties) before said past-due loans affect banks' profits

In general, banks' return on capital is high, above 15% annually for the system, driven by earnings in trading and low financing costs. One exception is consumer banking, due to its higher losses associated to the business cycle and the smaller weight of financial investment in its portfolios. In future, it is foreseeable that recent sources of gains will lose momentum because of interest rate normalization, and that the sources of losses will remain in place, as losses continue to be recognized in deteriorated portfolios. Accordingly, it can be expected that banks' profits will be smaller in the coming future.

The drop in lending and a higher proportion of liquid assets have favored the solvency of the banking system, resulting in the average capital adequacy index remaining above 13%. Other contributors to the evolution of the CAI have been additional capital contributions, the capitalization of a larger proportion of profits and the creation of higher profits in the year.

Regarding other risks, banks are holding more liquid assets and currency mismatches are almost nonexistent. However, the share of term deposits of mutual funds in banks' liabilities has increased. Accordingly, high dependence persists of some smaller banks on this type of funding. Despite their smaller relative size, it is important that the liquidity management policy of these entities account for this high dependence on large-scale sources, where renewal may be more difficult in periods of financial stress.

Finally, stress tests performed with information up to September 2009 show that, in a baseline scenario that assumes a recovery of economic activity and, therefore, of loans, the banking industry's profitability remains fairly flat, while the system's average CAI declines due to increased lending, but with no cases of banks falling below 10%. In the risk scenario, the system's average profitability and that of some specific banks is lower, while the average CAI increases because of zero growth in lending. In this scenario, some smaller size banks might require a limited reinforcement of their capital base, for its CAI to remain above 10%.

In the present context of incipient recovery, three external threats are identified facing the Chilean economy's financial stability. First, despite improved global growth expectations since the last Report, the threat remains of the world economy growing significantly less than assumed in the Monetary Policy Report's baseline scenario. Among the risk factors jeopardizing the recovery of world output, it is worth mentioning the weak spots that persist in the financial systems of developed economies, an early and disorderly withdrawal of macroeconomic stimulus and financial back-up packages, and the effects of price corrections in financial assets and commodities on the prevailing uncertainty. A second threat has to do with the effects on the domestic economy of non-banking capital flows to emerging economies being unchanged or increased, due to portfolio rebalancing or reallocation of external savings in economies with surpluses. The third threat is the Chilean economy encountering difficulties in its access to foreign lending.

The banking industry and other financial intermediaries should consider these threats in their operations and plans for 2010. On one hand, by assessing the adequacy of their capital base facing the risk of a new world meltdown, with repercussions in domestic output and employment. On the other hand, by prudently administering their liquidity in pesos and other currencies, actively diversifying its counterparties and sources of credit.

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