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Financial Stability Report



BANCO CENTRAL DE CHILE

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Summary

The international scenario has deteriorated with respect to the last Report. In the past few months, the world economy has been characterized by greater financial stress and a higher degree of risk aversion. This financial stress originates in three factors; first, an intensification of the European financial crisis, which increasingly affects both systemically-important economies and the banking system; second, the uncertainty about the U.S. fiscal policy; and third, the reduced growth expectations in advanced economies and signs of slower growth in emerging countries. These elements underscore the importance of the interaction between economic growth, fiscal solvency and bank exposure which, in practice, poses a serious challenge to the financial stability of a number of advanced economies.

The risk scenario of this Report assumes that the extension of the current level of stress in global markets will translate into a significant slowdown in world economic activity. The risk scenario could be linked to a worse-than-expected deterioration in the more advanced economies and/or an impact of international tensions on some emerging economy of systemic nature. These conditions could be aggravated if the banking or sovereign crisis in the Eurozone deepens, within a context where there is a limited capacity of the main advanced economies to implement countercyclical fiscal and monetary policies, and the capacity of some individual countries to support their financial intermediaries is smaller. If this scenario materializes, not only will external demand conditions for Chile deteriorate, but it is also very likely that external lending conditions to local agents will tighten, and the increased risk aversion will affect the domestic financial markets.

Most recently, external lending standards have tightened. Between the first and third quarter of 2011, long-term sovereign and corporate spreads increased 64 and 134 basis points, respectively. This situation was more evident since August and also coincides with a reduction in investments in local bonds by international investors, also affecting other emerging economies. After a long period of stability, the short-term cost of bank funding increased, to spreads around 90 basis points at the statistical closing date of this Report—that is, 30 basis points up from the first quarter. However, it is worth noting that domestic banks have a diversified financing base. Lately, they reduced funds coming from Spanish and Italian banks, a reduction they offset with increased funding from the U.S., Canada and Asia.

Domestic financial markets have been affected by increased external volatility. The prime-swap spreads at different terms have seen periods of high volatility associated, to a large extent, to external developments, and with tighter conditions lately. It should be noted that the higher external volatility also took its toll on the stock market, the forex market and the local fixed-income instruments, a situation common to other economies. This volatility, though lower than was seen in late 2008, could persist or even increase for as long as the fiscal and financial problems in advanced economies remain unresolved. It is important for financial agents and firms to internalize this increased volatility in their risk management activities.

In the corporate sector, the firms' debt continued to grow through the third quarter of 2011, with no material changes in liquidity, payment capacity or profitability indicators. Furthermore, despite the ever-increasing role of external debt as a source of funding, the corporate sector is showing stable and limited currency mismatch indicators. The analysis of a wide set of firms—including medium and small-sized ones—reveals only marginal variations in their currency mismatches since the last *Report*. Meanwhile, a closer look at the profitability, indebtedness and liquidity shows that, in general, there were no significant changes between the years 2007 and 2010. The exception is profitability of smaller-sized firms which, although it has recovered after the crisis, it is still below the levels of 2007. Despite the sector's favorable financial indicators, it must be noted that financial intermediaries should keep a vigilant attitude towards credit risk, considering the negative effects on external demand implied by the international risk scenarios.

No deterioration of households' financial situation is observed at the aggregate level. Private consumption has recovered quickly, while the debt posted an annual growth of 11% in the third quarter of 2011, led by bank loans (14%). The evidence at hand suggests that, so far, borrowing has not increased above its long-term-growth trend, and the average ratios of debt over income and financial burden are stable. By the same token, banking credit risk indicators for households have been fairly low during the past year. In the present scenario, however, close monitoring of household borrowing will be necessary, because if it continues to grow at the current pace, the households' debt and financial burden may rise sharply in case of a sudden and severe occurrence of the risk scenario just described. Finally, lower-income households could be more financially vulnerable considering the worsened of their financial indicators in the period 2007-09. Although the volume of debt of these households has no systemic importance, it may matter on some credit providers focused on the lower-income segments.

In a context of increased lending activity, bank solvency indicators remain high and stable. The lower profits of the past few months are originated in lower intermediation margins, mainly interest margins, which have fallen due to the faster pace at which the banks have passed on their rate increases to their liabilities. However, and despite the lower profitability, both the core capital (tier 1) and regulatory capital, measured with respect to risk-weighted assets, have remained close to 10% and 14%, respectively. This has been favored by, among other factors, capital increases of around US\$1.4 billion and liquid assets of over US\$3.0 billion as of the statistical closing of this *Report*. Already announced capital contributions of an additional US\$800 million are expected, which will allow keeping high solvency indexes.

The Chilean banking system continues to accumulate significant liquid assets and has also diversified and extended the terms of its funding sources. Liquid asset holdings rose in late 2008 and stabilized at around 18% of the industry's total assets. This growth is higher than can be explained by the change in the levels of sight deposits and external debt or by the lower level of activity observed after the crisis of 2008. As for bank liabilities, bond issuances and long-term certificates amounted to a combined US\$3.0 billion locally and US\$640 million in the external market, privileging, most recently, placements in emerging financial markets. In addition, the larger banks have contracted syndicated credits for US\$725 million, replacing other sources of shorter-term external financing. All this ultimately results in lower short-term mismatches in the margin, with enough room to meet the regulatory limits.

The persistent problems abroad, especially in the Eurozone, have begun affecting domestic banks' access conditions to external financing. Fiscal problems and their impacts on European banks have begun affecting the spreads of external credits, with no reduction so far in credit volumes or maturities. Still, and given the presence of banks established in Chile with a parent company or controller abroad, there is the risk that they will affect their respective subsidiaries. To this date, however, no relevant discrepancies are observed in the short-term external debt spreads of these banks, or in the valuations of issuances and/or transactions of their debt certificates in the domestic market. Nor has the risk-rating downgrade of some parent companies had an impact on the international or local risk-rating of their subsidiaries in Chile. The ratio of investments abroad over total assets does not differ much between national banks and foreign owned banks, both being below 4%, corresponding primarily to deposits in foreign correspondent banks. The significance of external financing does not differ between local and foreign banks either, with generally very low reliance on related bank financing. Finally, it is important to keep in mind that Chile's banking legislation mandates that the subsidiary fully constitutes its capital in the country before operating as a financial entity in the local market, and must fully comply with the requirements of solvency, provisions, market risk and liquidity provided for in the Chilean regulation.

The banking system maintains its capacity to absorb the materialization of a scenario of severe risk. Stress tests show that the industry's current level of capitalization can allow it to absorb an episode of GDP slowdown, an increase of financing costs in pesos and a depreciation, consistent with the scenario of external risk.

Internationally, a number of weaknesses persist—in the aftermath of the subprime crisis—that could trigger a significant deterioration in global activity and the world financial system. A particular concern is the macro-financial behavior of peripheral Europe and the United States. The worsened external financial conditions and the resulting world deceleration could have a negative impact on the Chilean economy. Although the analysis in this *Report* suggests that the Chilean financial system is prepared to confront this tightened external environment, it is important that credit users and financial intermediaries internalize these risks in their consumption, investment and financing decisions. In aggregate macro-financial terms, in the past few decades the country has made progress in building an economic policy framework that has already given proof of its ability to properly address difficult conjunctures.

Finally, since the last Report, a number of regulatory and financial supervision amendments have been implemented. In the first place, the Financial Stability Board began operating, which seeks to coordinate and propose measures to safeguard the integrity and soundness of the financial system, via the coordination and exchange of information between the competent authorities. In terms of consumer protection, a Law was enacted which grants greater powers and responsibilities to the National Consumer Service, Sernac, in financial services matters. In parallel, Congress has continued with the procedures to create a consolidated debtors data base. Also in progress is the bill seeking to modify the maximum conventional rate. It is important to note that the potential benefits of the regulatory amendments demand a proper evaluation of their direct and indirect effects on both users and providers of credit.



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