CBC-IADB Joint Workshop on "*Basel III in the Context of the Macroprudential Approach*"*

Opening Remarks by Mario Marcel, Governor of the Central Bank of Chile
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Good morning and welcome to the "Basel III in the Context of the Macroprudential Approach" workshop which is co-organized by the Central Bank of Chile and the Inter-American Development Bank.

It is a pleasure to host this event in Santiago, at a very appropriate timing. After a year and a half of legislative discussion, on January 12th of this year, the new General Banking Law was enacted. This is the most significant change to solvency regulations since 1986, setting the basis for the implementation of the Basel III framework in Chile.

A second reason goes back 35 years. In a few more days, the Central Bank will receive the last repayment of the subordinated debt originated in the rescue of the Chilean financial system of the early 1980s. It has been a long way since this episode, and the fact that only now can we finally put it behind us, highlights the importance of doing everything in our reach to prevent the occurrence of major financial disruptions.

Allow me to go briefly over the history of the Chilean financial system over the last five decades, and how regulation has reacted and evolved over time.

Some 50 years ago, banks where almost the only source of financing for companies and households. The Chilean economy was closed to international trade and capital flows, interest rates were regulated, credit was restricted, and banking activity was largely controlled by the State.

In the second half of the 1970s the banking sector was privatized and liberalized. However, this was not accompanied by adequate regulation and supervision; and a relatively small financial system built major vulnerabilities. When macro policy missteps and external shocks hit in 1982, the banking sector was not just a weak link, but amplified them into the deepest economic and financial crisis in a generation.

The Chilean financial crisis of the 1980s and the origins of the subordinated debt

Financial crises are abrupt, costly and protracted affairs, and the Chilean financial crisis of the early eighties was no exception. This crisis is often quoted as one of the top 25 most severe financial crises in modern history. In 1981, annual output growth went from positive 9% in the first quarter,

* I thank the comments and suggestions in preparing this speech to Solange Berstein and Mauricio Calani.

to 0% in the fourth quarter, and to minus 14% in 1982. That same year, unemployment reached a record of 25%, and businesses all over the country were seriously hampered, ultimately affecting their payment compliance. Banking profitability went quickly to negative territory and the delinquency rate quadrupled to 15% of the total portfolio, putting several banks solvency and operations at risk.

Several factors contributed to the deterioration of the macroeconomic environment in 1982. External interest rates rose, the availability of external credit decreased, and terms of trade worsened in the wake of the escalation of oil prices. This put enormous pressure on the Chilean peso—which had been under a fixed exchange rate scheme since 1979—. This regime broke down dramatically and spread to almost all business sectors, given large FX exposures, and heavily leveraged financial conglomerates. All these factors interacted with one another to become an outright banking crisis. But, whatever the causes of the crisis, unsustainable debt was mostly explained by internal vulnerabilities: inappropriate regulation, weak supervision, and lack of attention to excessive credit growth, leveraged on a fixed exchange rate scheme.

Although the first aid took the form of "emergency loans" by the Central Bank to commercial banks, during the following year conditions deteriorated rapidly enough to lead to the intervention of 11 banking institutions. Another 8 were added in 1983, including the two largest banks in the system. In all, the intervened institutions represented 60% of total credit. All directors and executives of these institutions were, removed from their posts, and replaced by provisional administrators.

Measures to fight the crisis aimed at the liquidation of non-viable banking entities, improvement of balance sheets of viable entities through the purchase of deteriorated portfolios, and the reduction of financial burden of bank borrowers through debt reprogramming and preferential exchange rates. In 1985, this extended to the recapitalization of the intervened banks, through the so-called "popular capitalism" program.

Perhaps the most important program was the purchase of deteriorated portfolios by the Central Bank under a variety of schemes, including repurchase agreements, and in exchange of debt instruments, liquid resources, and a new liability called "Subordinated Obligation". The impact of these programs on the assets side of the Central Bank balance sheet was huge, and so were the costs of the complete rescue plan. Altogether, it is estimated that only the direct fiscal cost of the Chilean Financial Crisis of 1982 reached 41% of GDP.

The aftermath of the crisis

The lessons learned from this crisis highlighted the fact that banking regulation and supervision needed to be substantially upgraded. In 1986, the General Banking Law introduced limitations on currency mismatch, constraints on related party lending, and restrictions for banks to receive goods instead of liquid resources; all of them, elements which were common practice before the 1982 crisis.

Paradoxically, what could be considered harsher regulation did not hamper financial deepening. Instead, it fostered solvency and credibility of the banking system and allowed its healthy development in the ensuing decades.

Regulation and Financial Development

Credit has a valuable role in the economy. Financial intermediaries channel resources from agents that save, to agents that need to borrow to smooth consumption or finance profitable projects. Intermediaries contribute to link both sides and bridge gaps of incentive and information frictions, by managing credit risk, liquidity risk and transforming maturities; thus contributing to a better resource allocation and fostering growth.

Proper regulation, with a sound balance of risks assessment, can help prevent unsustainable and irresponsible credit growth, reducing the probability of insolvency while allowing banking institutions develop profitable businesses. So, it is not a question on whether or not to regulate, but rather how much to regulate, and how to do it without impairing efficient allocation of resources.

Regulation has not been an obstacle to financial development in Chile in the 35 years since the debt crisis. Chilean capital markets—broadly defined—evolved in tandem with economic growth. The 1986 Banking Law was key in fostering this process, but it was hardly the only piece of the financial architecture that changed significantly. Notably, the creation of a defined contribution pension system, and subsequent capital market reforms, together with capital market openness, have dramatically changed the size, composition, depth, and strength of the financial sector in Chile.

By funneling household savings into capital markets, Pension Funds were especially important to the early development of a deep debt market; and their contribution to market-making benefited from a stable macroeconomic environment with controlled inflation, extensive use of the UF, and the restructuring of Central Bank's debt into longer maturities. A deeper and more liquid debt market also facilitated the pricing of debt issued by private companies in local markets.

External financing for the banking and corporate sectors has evolved as well. Macroeconomic stability under a flexible exchange rate, together with regulatory changes, have fostered the development of overseas bond market for Chilean companies. Corporations have learned to operate in a flexible FX environment by using both, natural and market-based FX risk hedging instruments. This, in turn, has also been supported by the development of the derivatives market, in which Pension Funds have been key counterparts as well.

By now, the Chilean financial sector is one of the most developed in the emerging world. It has transited from being largely dominated by traditional banking to being composed by several other market participants, including Pension Funds, General Fund Administrators and Insurance Companies; among others. Assets under management of these non-bank investors went from less than 1% of GDP in 1984, to 65% in 2000, and to almost 100% of GDP in 2018. This development has translated in improved access to alternative sources of funding by Chilean corporations. Currently, around 85% of total corporate bonds are held by institutional investors, as a result of which reliance on banking credit of these corporations has gone from 91% of financial debt in 1986 to around 25% in the recent years[1].

Financial development has been important not only for firms but also for the country. A deeper and far-reaching financial system contributes to building financial and economic inclusion, and financial stability against external shocks. In this respect, the Chilean financial system shows better performance than other Latin American and Emerging economies, in dimensions like market capitalization, number of branches per inhabitant, use of derivatives, and participation in domestic credit to the private sector, to name a few.

Nonetheless, increased development and complexity of financial markets also means that risks may be higher, and that a stronger and more sophisticated regulatory framework is required.

The New General Banking Law and future challenges

The New General Banking Law, takes important steps in this direction, by embracing the recommendations of Basel III on banking capital and reserve requirements, as well as on corporate governance. Supervision is also improved under the new law, by merging SBIF into the new Financial Markets Commission (CMF) in order to have a system-wide oversight of risks and vulnerabilities in financial markets.

Through the day, the different panels will discuss the role of macro prudential policies and the implementation challenges in adopting Basel III standards. The main goal of these standards is to increase the resilience of the banking sector, by increasing quantity and quality of capital requirements. This framework combines bank-specific measures with macro prudential actions to contain potential systemic risk. In this respect, one of the new tools is the countercyclical capital buffer: an additional capital requirement that could be activated and deactivated by the Central Bank depending on the state of the financial cycle, and whose main goal is to preclude the incubation of systemic risks and increase the resilience of the system as a whole.

Still, there are a few challenges ahead that we need to address to have an even more robust financial system. In particular, two tasks seem more urgent than others. Namely, Resolution of Financial Institutions and Deposit Insurance. While the new Banking Law includes some provisions in this respect, by introducing stronger early-intervention measures, these need to be further

[1] Based on Agosín et al. (1999) and Espinosa and Fernandez (2015).

developed to provide a comprehensive framework to deal with banks in trouble or on the brink of insolvency.

Once the preparatory phase of the General Banking Law, including a unified supervisor, is fully completed, we hope that the Central Bank and the Government can advance in drafting a legal proposal on these issues. Certainly, these areas will be important points in the IMF's Financial Sector Assessment Program (FSAP) update of 2020, and it is important that we get there with the job well advanced.

Acknowledgements

Finally, allow me to thank the presenters for sharing their interesting research insights here with us in Santiago. I also thank the organizers from the Central Bank of Chile and the IADB in putting together this rich agenda from which we will certainly distill conclusions to guide our work forward.

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