Chile’s Experience in Macroprudential Policy and Institutional Governance

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BOC-CIGI-IMF-PIIE Joint Workshop
“Re-Inventing the Role of Central Banks in Financial Stability”

MAY 2016

Agenda

- Disclaimer
- A changing governance structure of regulation and supervision
- Macroprudential policy implementation
- Coming challenges

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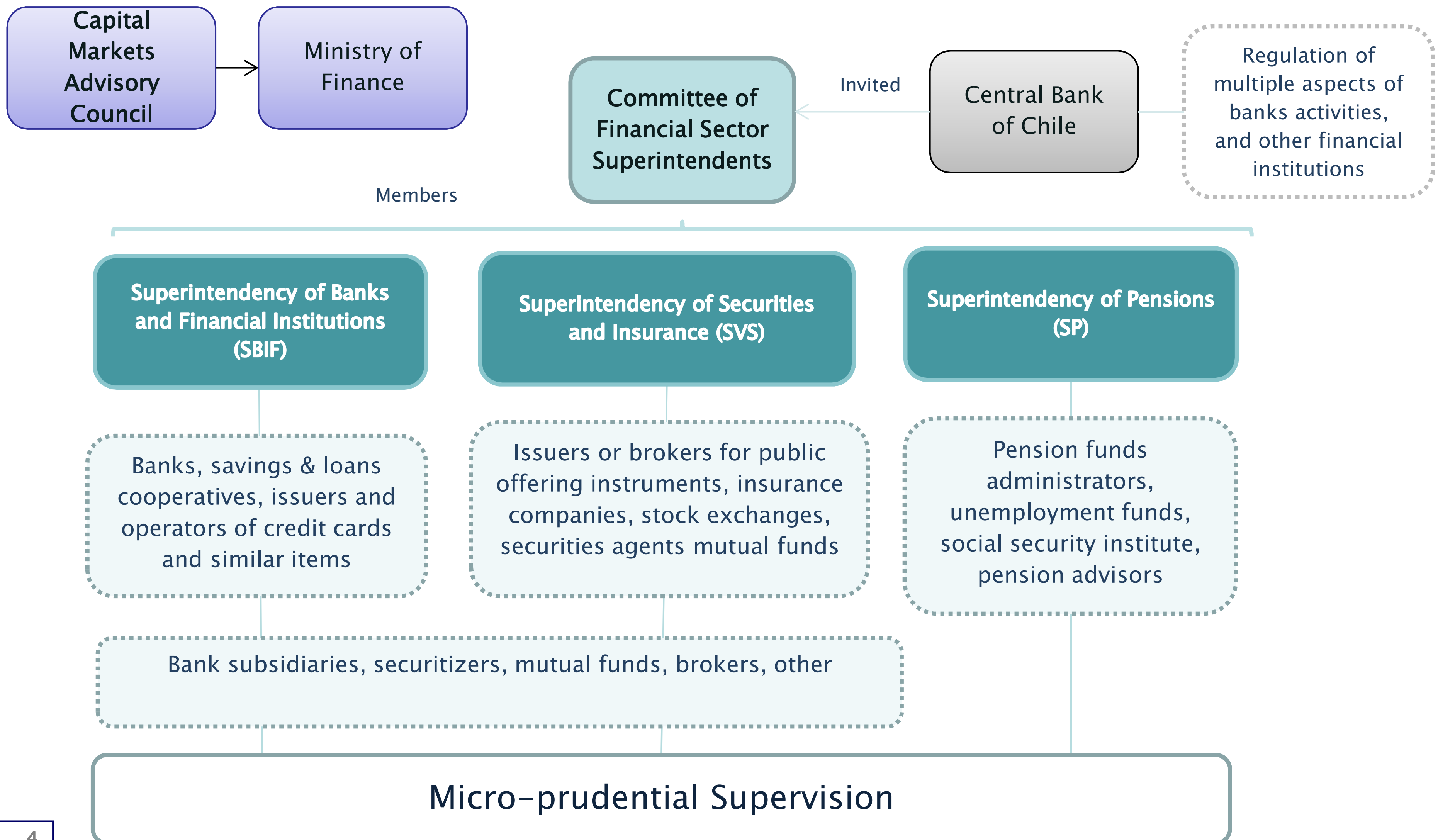
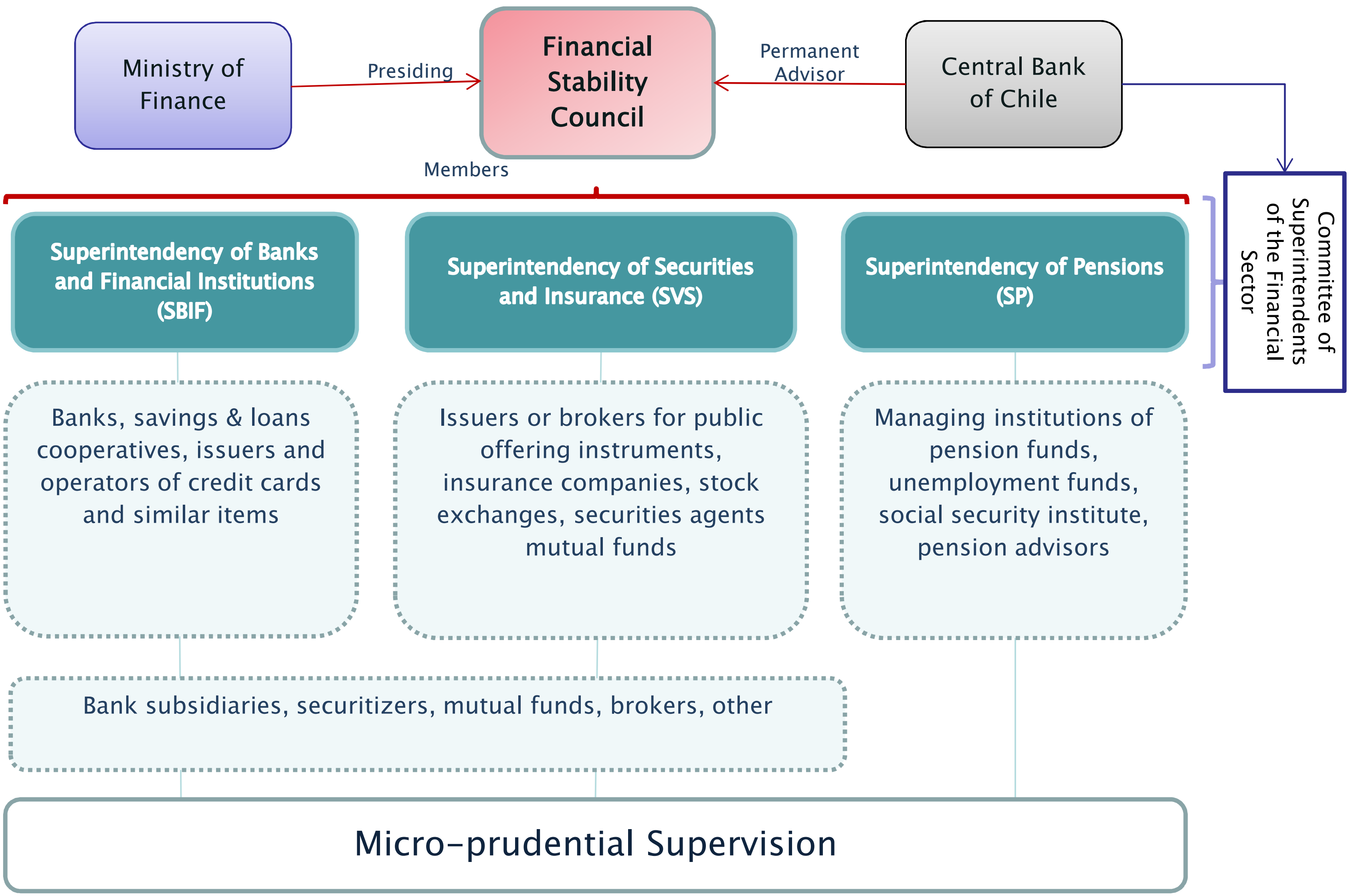
Pre-GFC structure of financial regulation and supervision based on lessons and reforms of the 1980's



Post-GFC analysis: the Desormeaux commission and its recommendations

- The Chilean financial system endured well the last two international crises (Asian and 2008-09), but a reassessment in the light of international developments was deemed necessary.
- In 2010, the Ministry of Finance formed the Commission for the Reform to Financial Regulation and Supervision (the Desormeaux Commission).
- After a a period of broad consultation, the Commission delivered the "Final Report of the Commission for the Reform to Financial Regulation and Supervision" with a number of recommendations.
- Most prominently, the need for a formal coordinating body: the Financial Stability Council (CEF).

The current structure of financial supervision



CEF mandate

- *Safeguard the integrity and soundness of the financial system, providing the necessary mechanisms for the coordination and exchange of information required for a precautionary management of systemic risk and to resolve critical situations involving the exercise of the functions and powers of the Superintendencies operating in the Economic Area*

The creation of the CEF

- First established by Presidential decree in 2011 as an advisory body to the Ministry of Finance in financial stability matters
- Its creation by law in 2014 makes no significant changes to the structure or operation of the CEF but gives firmer legal ground to its operation, fostering the exchange of information subject to reserve between the parties. Thus any person who delivers information under the CEF's framework and for its purposes is exempted from legal liabilities
  - Important lesson from first stages of operation
- In accordance to the purpose of strengthening the supervisors, this law also amended other laws to give more powers to supervisors to obtain information of financial conglomerates (plus certain requests to its controllers).

CEF powers

- Request the Technical Secretariat and financial superintendencies to conduct studies to monitor the stability of the financial system, as well as having them outsourced
- Request the financial superintendencies any information, even if classified, that may be necessary to assess potential risks to financial stability
- Recommend to the competent departments or agencies policies that contribute to financial stability.
- Perform other requests for information and recommendations necessary to fulfill its role of safeguarding the financial stability of the Chilean economy

CEF governance

- Collegiate body: presided by the ministry of finance, decisions are subject to vote and adopted by simple majority of attending members (quorum: finance minister plus 2 out of 3 superintendents)
- Meets at least monthly
- As permanent advisor, the President of the Central Bank has right to speak but not to vote
- CEF powers are not above the legal mandate of their members. Thus, its opinions and recommendations are not binding
- Accountability through report to Finance Committees in Congress and the release two weeks after each session of a brief minute of the proceedings

Examples of issues

- Presentations by task groups on relevant issues: risk analysis; conglomerates; repos, shadow banking, etc.
- Analysis of international and local macroeconomic and financial conditions and their potential impact on financial stability:
  - Financial market analysis: funding cost, issuances, etc.
  - Changes in portfolios of local institutional investors (PF, MF, IC)
  - International capital flows to EME and Chile
  - Analysis of specific situations experienced by local financial market participants that may threaten financial stability in Chile
- Review of regulatory changes under discussion and likely impact on financial stability
- High-level communication with international organizations

Some tradeoffs

- Coordination vs. autonomy
  - Independence of Central Bank and autonomy of supervisors are well established pillars of effective monetary policy and financial supervision since the 1980's
  - But taken to an extreme they may lead to a "silo view" of the financial system and to overlook policy externalities => Need for a comprehensive view
- CEF aims to balance this tradeoff by providing an institutional framework for information sharing and exchange of opinions

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A tough regulatory baseline for banks

Allowed operations for banks in Chile (LGB)
Taking deposits, offering current accounts, making transfers and payments
Issuing senior bonds, mortgage linked bonds, guaranteed and unguaranteed loans
Issuing letters of credit, payment orders and guarantees of deposits
Issuing and trading commercial paper
Trading derivatives according to Central Bank regulations, and engaging in exchange rate operations
Offering services of securities custody
Issuing and operating credit cards
Acting as investment agent and stock underwriter
Buying, keeping and selling securities and other assets in order to provide banking services;
Establishing on-shore subsidiaries and acquiring ownership stakes in foreign firms
Subsidiaries in Chile are allowed to act as securities agents; broker dealers; Mutual or investment funds administrators; and insurance broker.
Subsidiaries are not allowed to buy shares unless it is stricly necessary for its functions (parent banks are not allowed to buy or hold shares)

Crucially: no stocks, no commodities, limited set of derivatives

A tough regulatory baseline for banks

Risk weights in the standard Basel II model and in Chile (General Banking Law)

Bank Assets	Basilea II	LGB
Cash	0%	0%
Exposure to sovereign or central bank debt	0-100%	o 100%(2)
Trade credits (1)	0-100%	100%
Commercial mortgages	100%	100%
Multilateral development banks	0%	100%
Banks (1)	20-100%	100%
Consumer	75%	100%
Home mortgages	35% o >	60%
90-day default portfolio (net of provisions) (1)	100%	100%
90-day default portfolio (net of provisions), mortgages	50-100%	100%

(1) A weight of over 150% could be applied to: sovereign, state-owned or bank debt or corporate securities rated lower than B-; commercial credit rated lower than BB-; and mortgage loans in default with provisions of less than 20% of the debt.
(2) Sovereign or Central Bank of Chile debt: 10%; remainder: 100%.
Source: Central Bank of Chile, based on BIS and SBIF data.

A simple balance sheet of the banking system

Assets of banking system
(%)

Assets	2008	sept 15
Cash	4	5
Consumer loans	8	8
Commercial loans	42	41
Home mortgages	16	19
Foreign trade	8	6
Securities	12	9
Derivatives	7	7
Other assets	3	5
Total assets	100	100

Liabilities of banking system
(%)

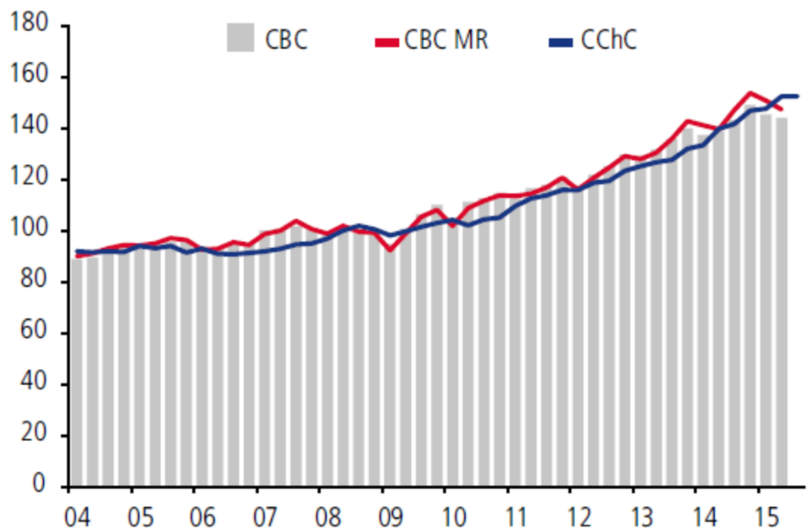
Liabilities	2008	july 15
Demand deposits	13	17
Time deposits	47	39
Foreign liabilities	7	4
Foreign bonds	1	5
Debt securities	13	14
Derivatives	6	7
Other liabilities	7	6
Capital and reserves	8	8
Total	100	100

Some examples

- Examples of areas where the international discussion calls for possible macroprudential policy activism
  - Housing valuations and LTV ratios
  - Capital inflows and spillovers
  - Corporate leverage and FX-mismatches
  - Shadow banking
- Our experience has been in general to eschew activism and rely instead on "simplicity by design" of the overall macro financial framework

Housing valuations and LTV ratios

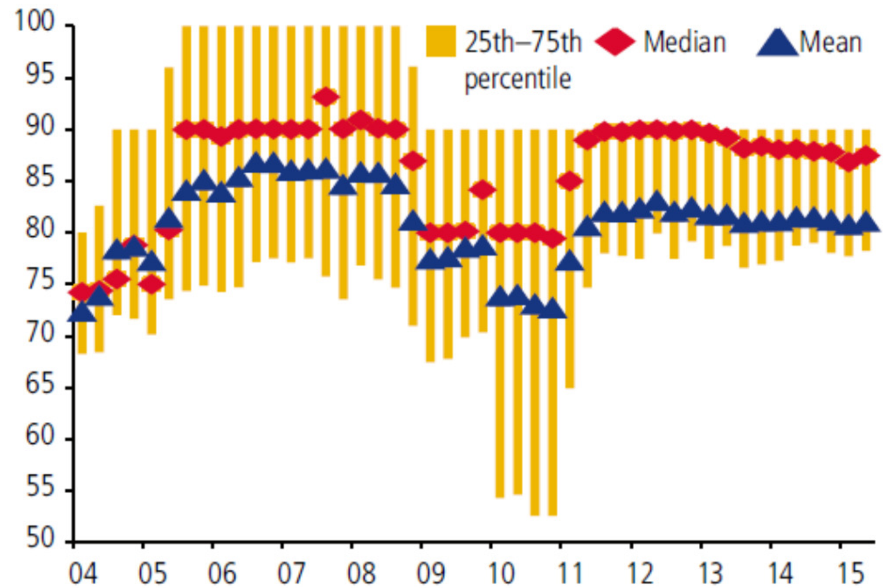
Home prices in real terms (*)
(fixed-base index: 2008=100)



(*) HPI, stratified method. CChC uses a new house hedonic model.

Source: Central Bank of Chile, based on data from the Internal Revenue Service (SII) and CChC.

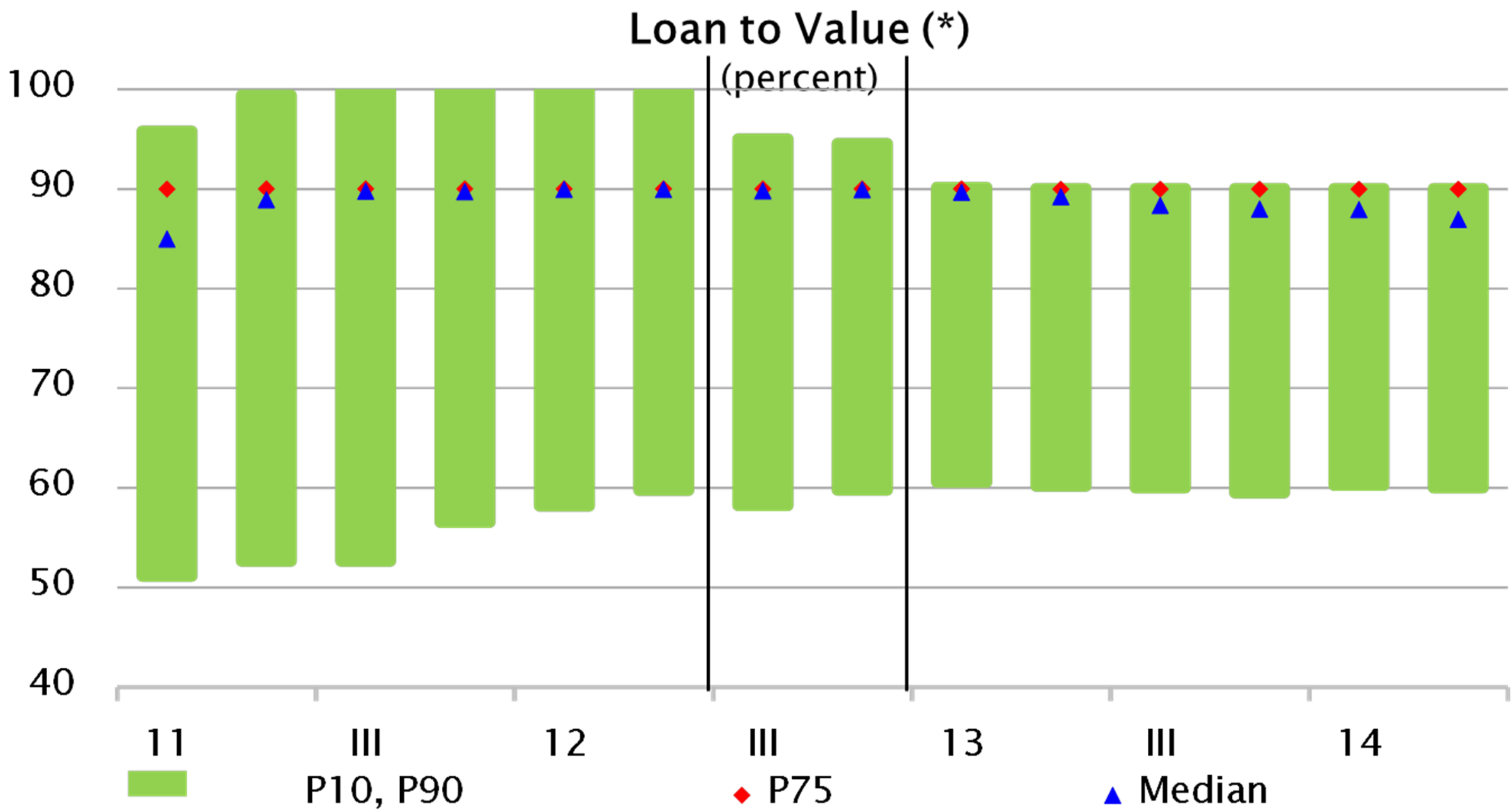
Residential loan-to-value ratio
(percent)



Source: Central Bank of Chile, based on data from SII.

Source: Financial Stability Report, 2nd semester 2015

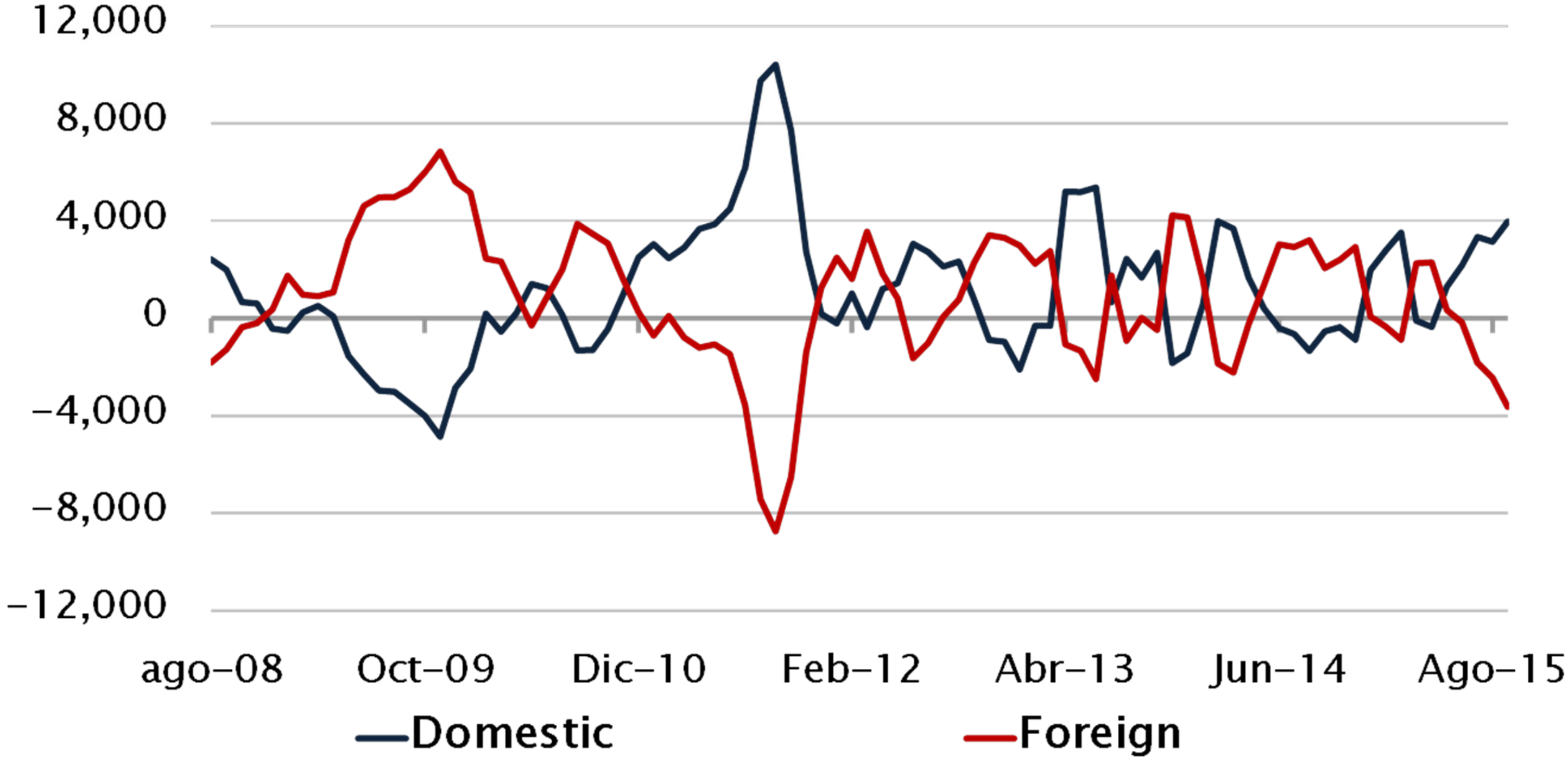
Housing valuations and LTV ratios



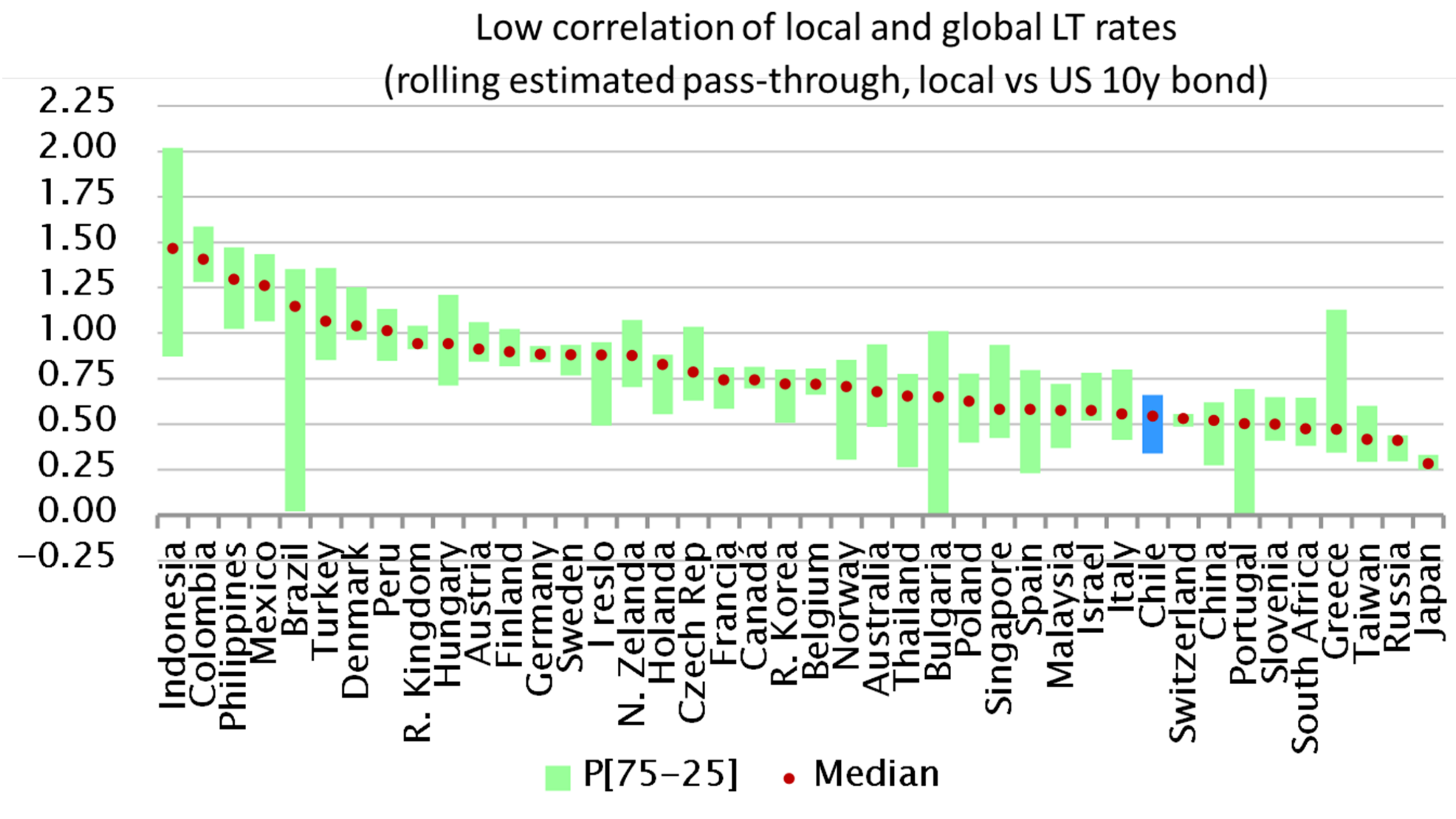
(*) The vertical dashed line indicates the central bank warnings about possible risks associated with the dynamics of the housing market.
Source: Central Bank of Chile, based on data of SII.

Capital inflows and spillovers

Pension funds have dampened movements in capital inflows from non-residents
(US$MM, PFAs 3m moving cumulative flows)



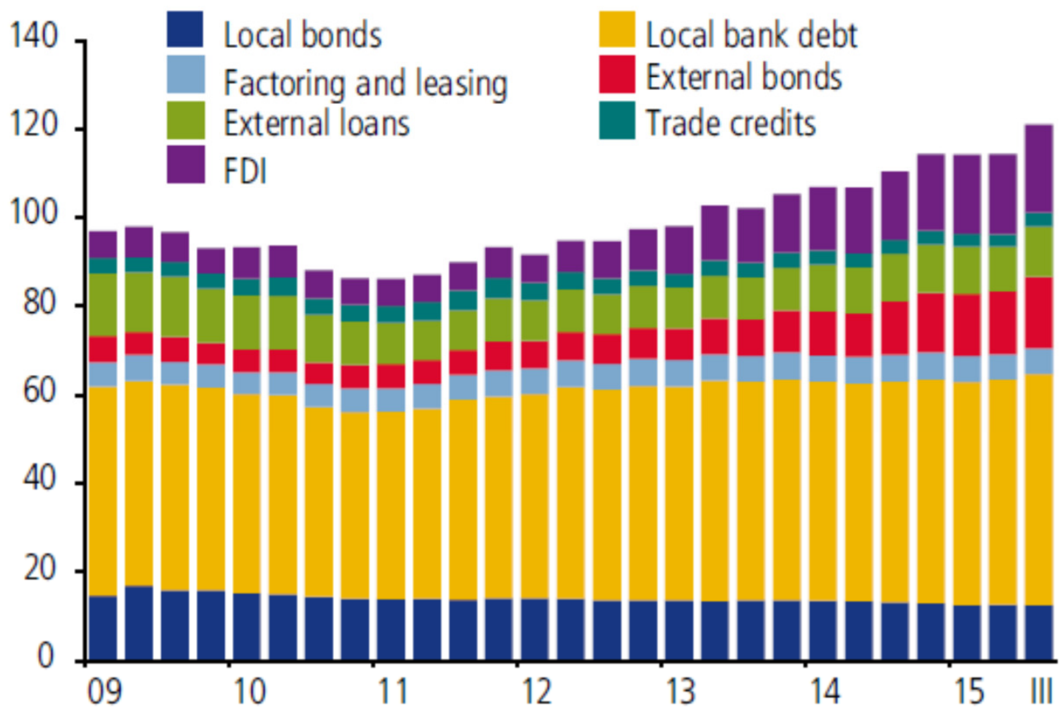
Capital inflows and spillovers



Corporate leverage and FX mismatches

Total debt of nonbank firms (1) (2)

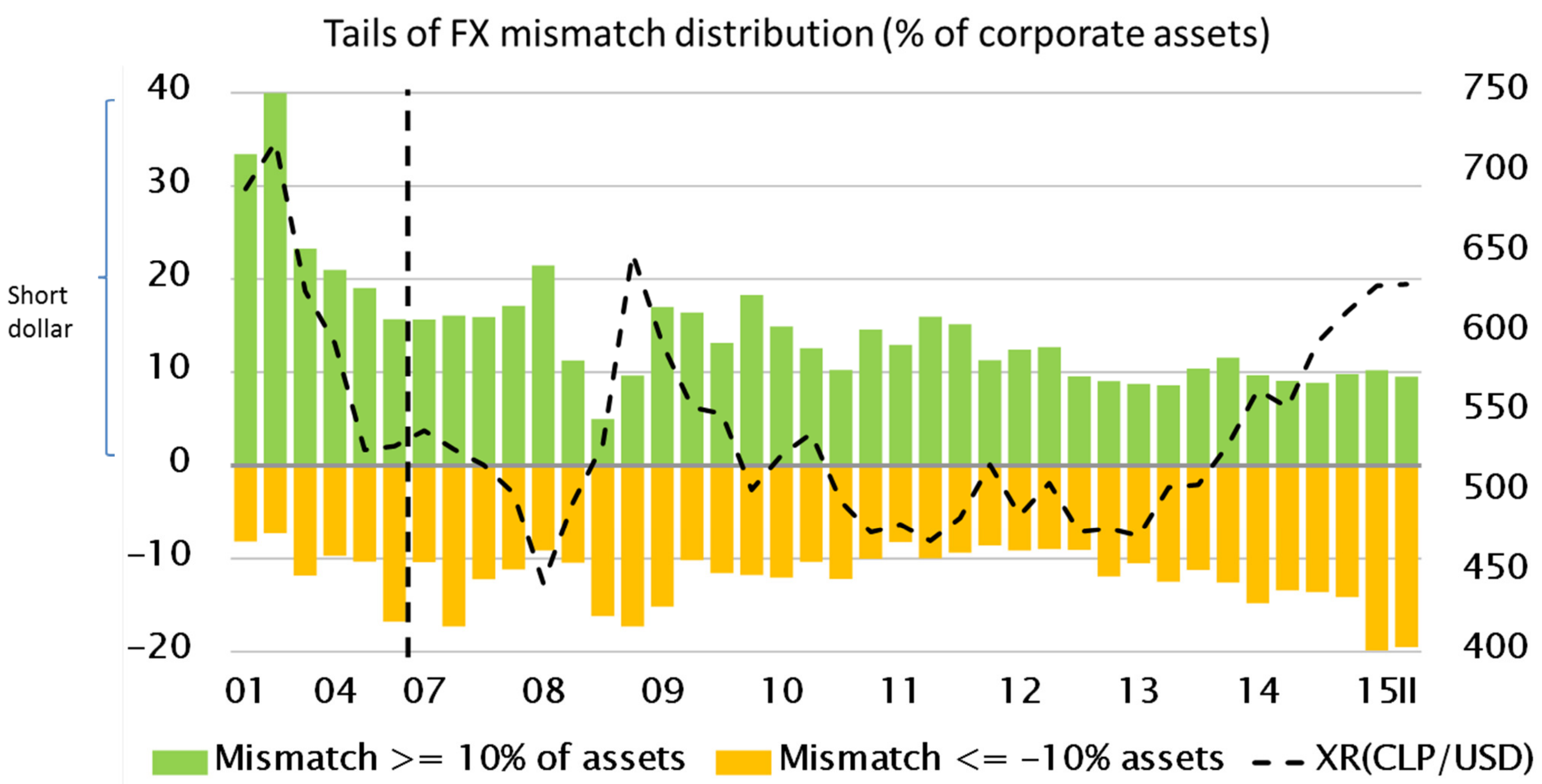
(percent of GDP)



(1) Based on firm-level data, with the exception of factoring and leasing, securitized bonds and commercial papers.
(2) For more detail on the series, see the statistical appendix.

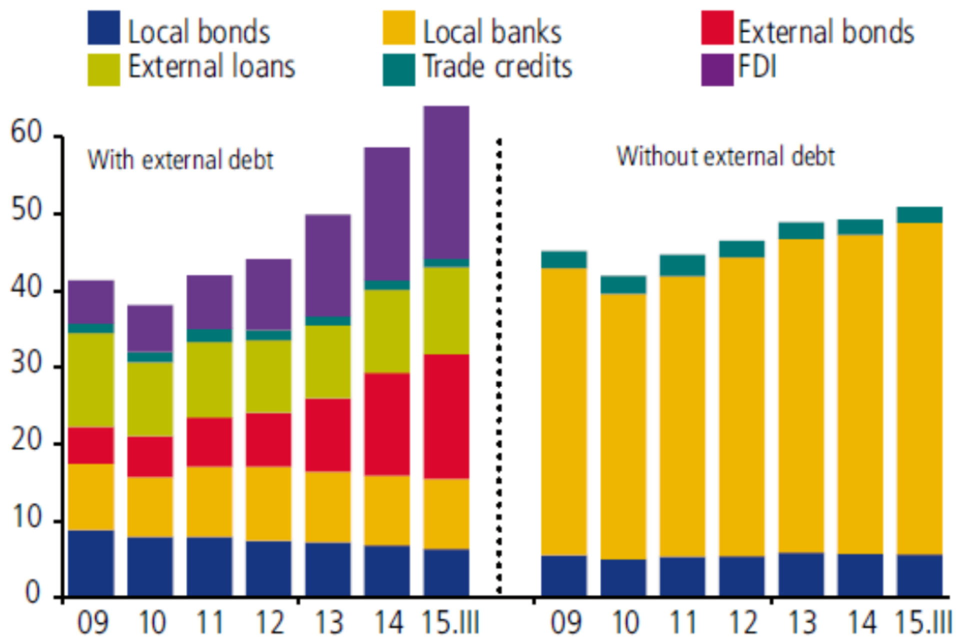
Source: Central Bank of Chile, based on data from Achef, SBIF and SVS.

Corporate leverage and FX mismatches



Corporate leverage and FX mismatches

Total debt of firms with and without external debt (1) (2) (3)
(percent of GDP)



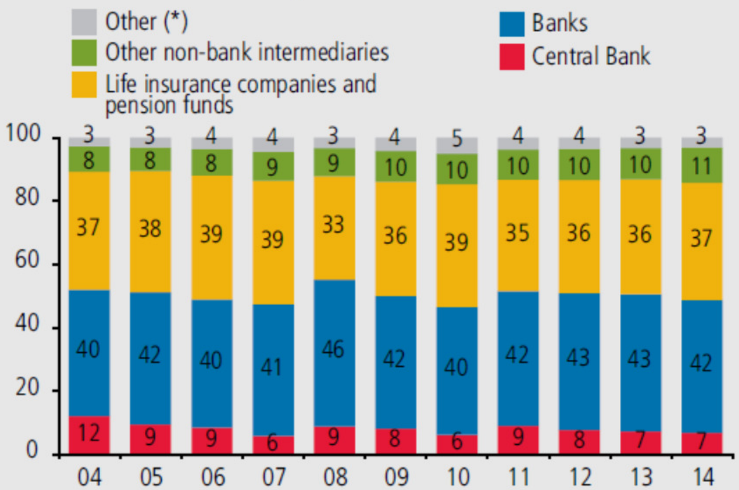
(1) Firms with external debt are defined as having had external loans, external bonds or FDI at least once between 2009 and 2015.
(2) Excluding factoring and leasing, securitized bonds and commercial papers.
(3) For more detail on the series, see the statistical appendix.

Source: Central Bank of Chile, based on data from SBIF and SVS.

Shadow banking

Financial intermediaries in Chile

(percent of total financial assets)

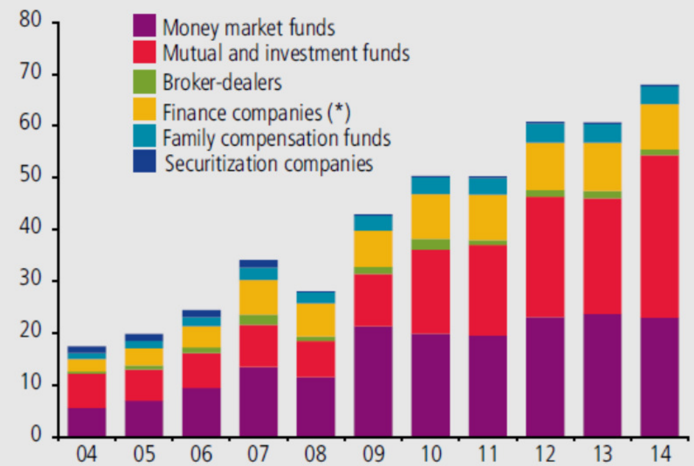


(*) Includes public financial institutions, cooperatives supervised by the SBIF, equity investment and mutual funds, and financial auxiliaries.

Source: Central Bank of Chile, based on data from SBIF, SVS, SP and SuSeSo.

Types of non-bank intermediaries in Chile

(US$ billion)

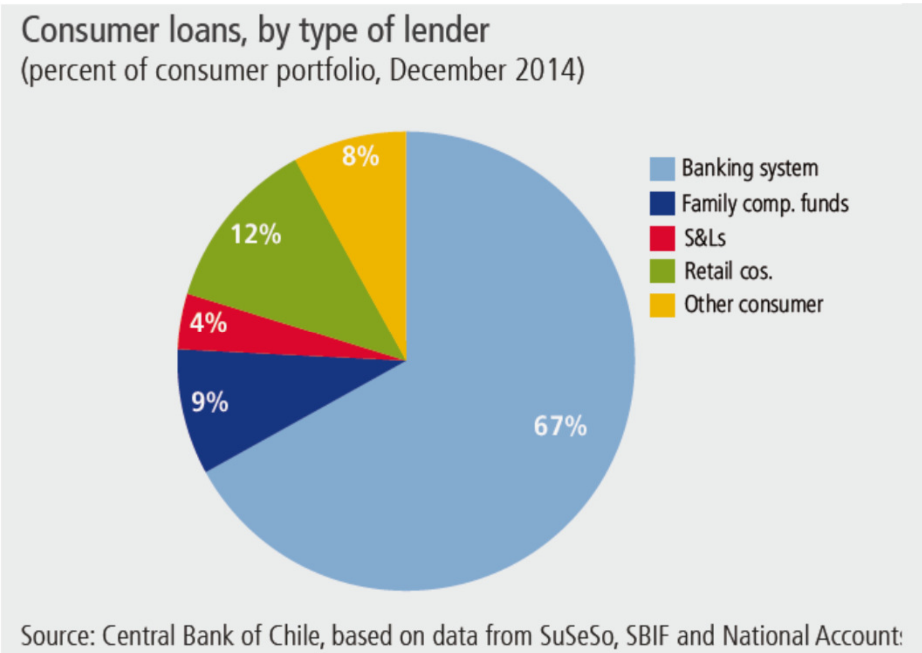


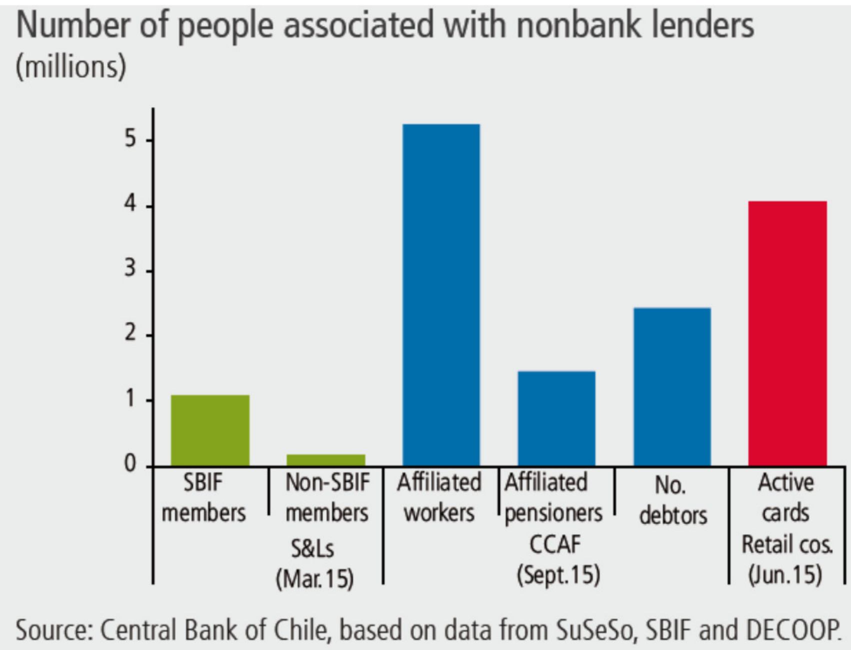
(*) Includes leasing and factoring companies, non-bank credit card issuers and car financing companies.

Source: Central Bank of Chile, based on data from SBIF, SVS and SuSeSo.

Restrictions on deposit taking and the explicit definition of regulatory perimeter limit the scope for non-bank leveraged financial intermediation with systemic implications

Shadow banking





Non-bank consumer lending has limited systemic implications in terms of size but poses challenges on consumer protection dimensions

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Coming challenges

- The current administration has stated the intention to submit legal reforms to the Banking Act so as to put it in line with global standards and Basel III

  - Capital

  - Resolution

  - Governance

- Although our banking regulation has served us well, it is appropriate to update some elements given the international discussion

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