



Development of the Chilean Capital Markets

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Outline

- From Financial Repression to Crisis, Stability and Growth (1970-99): A Quick Overview.
- Where do we stand?
- Recent developments and remaining challenges.

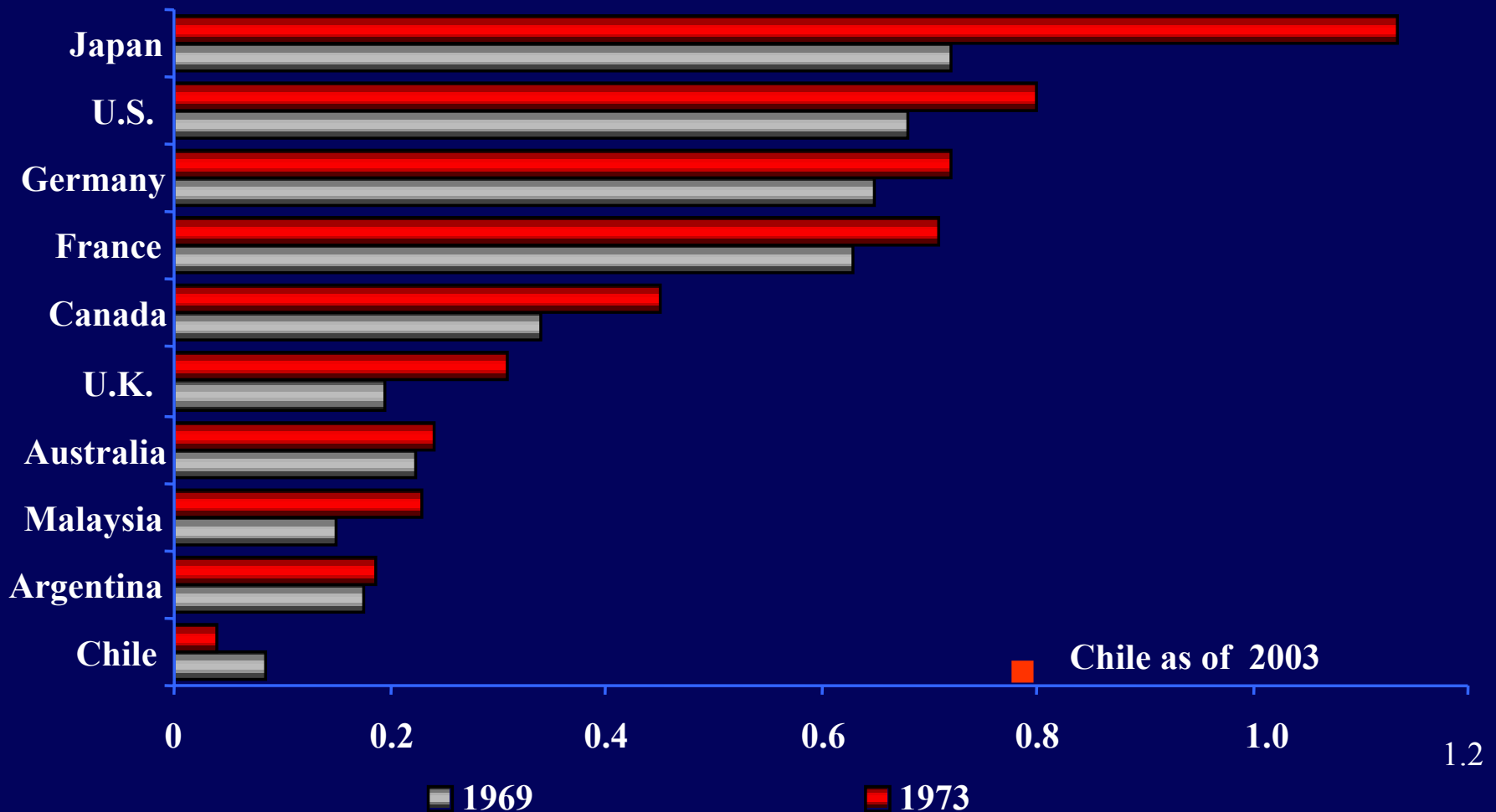
I. From Financial Repression to Crisis, Stability and Growth (1970-99)

1970-1999: Overview

- Initial conditions: financial repression
- 1974-1981: financial liberalization with weak institutions and weak macro fundamentals
- 1981: pension reform
- 1982-1983: economic and banking crisis
- 1984-1987: recovery and reordering
- 1987-1999: steady growth and financial deepening

Financial Repression: 1969-73

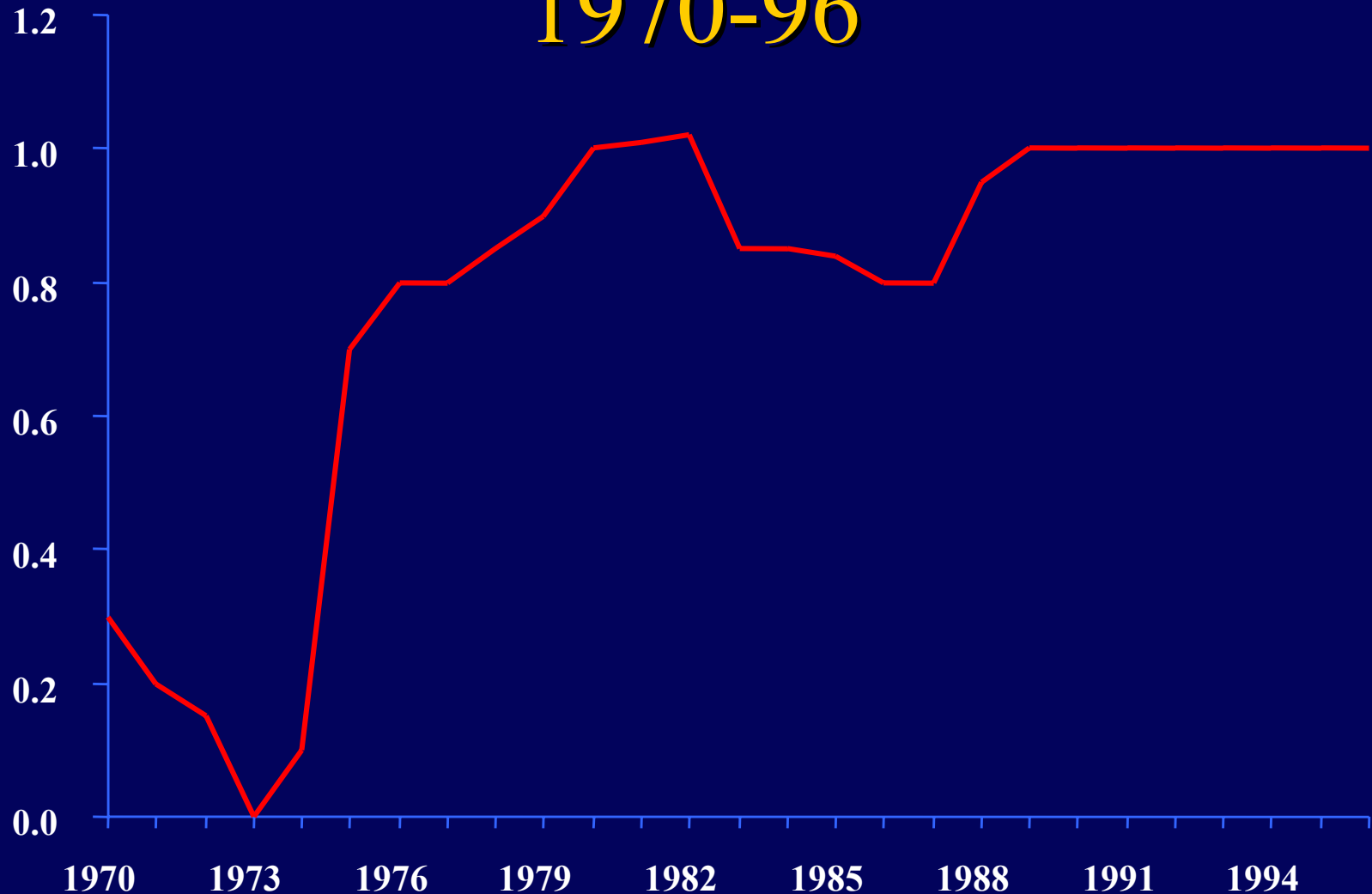
Private credit by deposit money banks and other financial institutions to GDP



Financial liberalization (1974-81)

- Interest rate liberalization
- Abolishment of credit ceilings and mandatory lending to priority sectors
- Reduction of banks' reserve requirements
- Partial opening of the capital account
- Liberalization of the banking sector
 - Reduction of barriers to entry
 - Privatization of state banks
 - Creation of the supervisory agency (SBIF).

Financial liberalization Index 1970-96

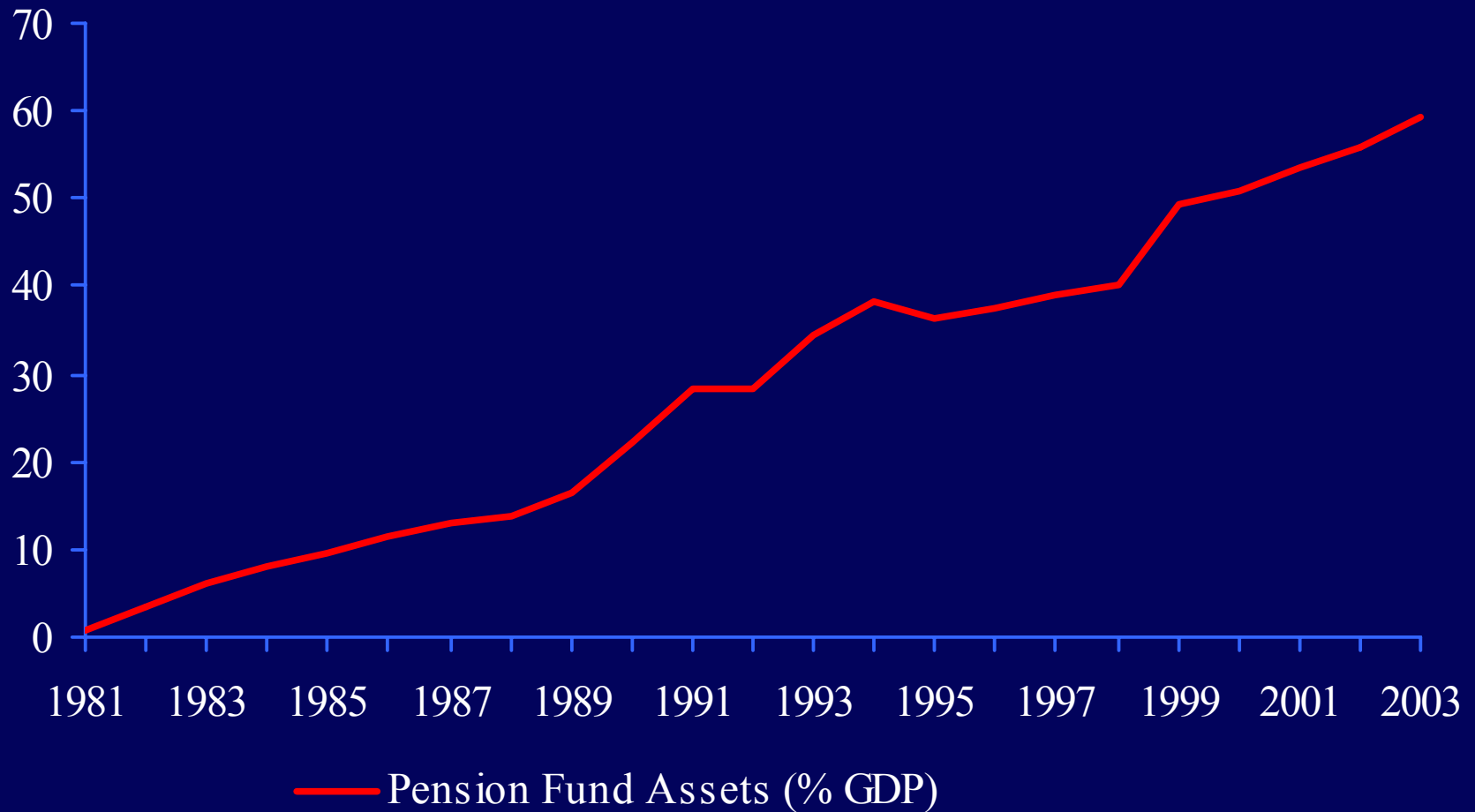


Source: Gallego and Loayza (2000)

Pension reform (1981)

- An important development in this period was the pension system reform which replaced the “old and bankrupt” pay as-you-go for a fully-funded capitalization system:
 - Mandatory for new workers
 - Pension funds managed by competitive private institutions
- This created a new institutional investors base, contributing to improvements in corporate governance and to the emergence of long-term funding.

Pension reform (1981)



Source: Central Bank

Economic and Banking crisis (1982-83)

- All of the above, along with macro reforms and favorable external conditions, led to a lending boom, asset price bubbles, overheating and very rapid economic and financial sector growth.
- Drastic changes in relative prices, high inflation and the lack of a well-developed regulatory and supervisory framework led to banks incurring in unchecked risks and mounting systemic financial fragility (under provisioning and reporting of NPLs; connected lending; currency and maturity mismatches; overlending; etc.)

Economic and Banking crisis (1982-83)

- The external shock of the early 80s was all that it took to unleash a major crisis.
- The crisis is among the costliest in the world and its full resolution took a long time.

Recovery and reordering: 1984-87

- Major reforms and measures during this period comprise:
 - Liquidation or rehabilitation/privatization of failed financial institutions;
 - Rehabilitation of corporate and household sectors through debt rescheduling and other programs;
 - A new General Banking Law (1986)
 - A new Bankruptcy Law (1986)
- The clean up and reordering process set the basis for a sustainable economic recovery
 - Average growth during 1985-97 reached 7.3%.

Steady Growth and Financial Deepening (1987-99)

- One legacy of the crisis was a conservative approach towards banking and finance in general, that limited the development of the sector.
- This approach was not fully compatible with the globalization trend and the growing integration of Chile into the world economy:
 - Chilean capital markets remained very rudimentary after the clean up;
 - And the rapid growth of pension funds required enlarging the set of investment (and hedging) opportunities.

Steady Growth and Financial Deepening (1987-99)

- Thus, during this period the reforms continued:
 - Authorization of Foreign Capital Investment Funds (FICE) to invest in the local stock market;
 - Privatization of public utilities and other SOEs;
 - Broadening of Institutional Investors' set of eligible investments;
 - Securities Settlement System: new centralized custody and settlement system (DCV);
 - Amendment to the banking law (1997);
 - New bank licenses;
 - Deregulation of mutual funds industry;
 - Securitization, etc.

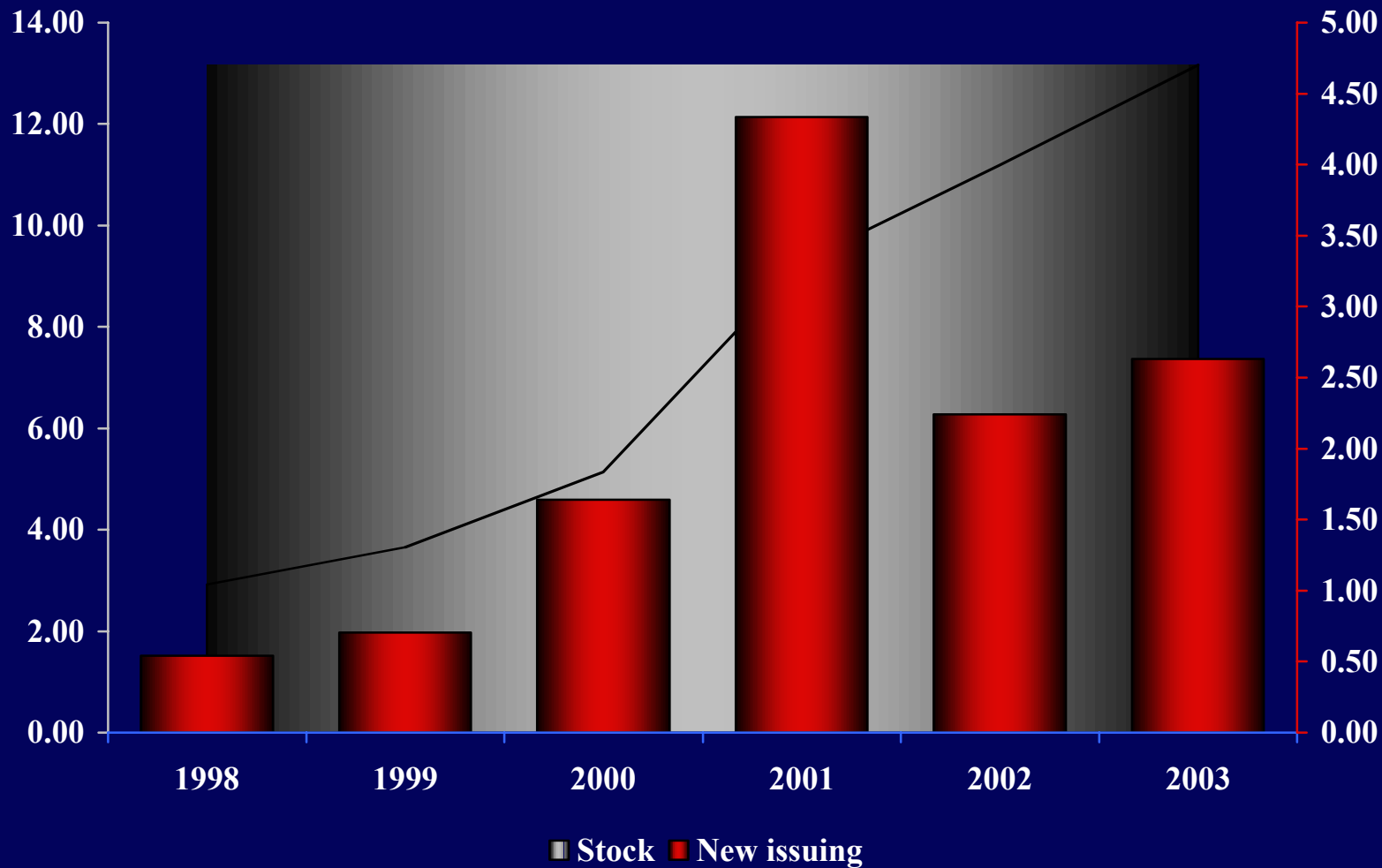
II. Where do we stand?

Where do we stand?

- During the last fifteen years the outstanding record in terms of inflation and sustainable macro policies has contributed to a substantial development of the financial system.

Corporate Bonds

(% GDP)

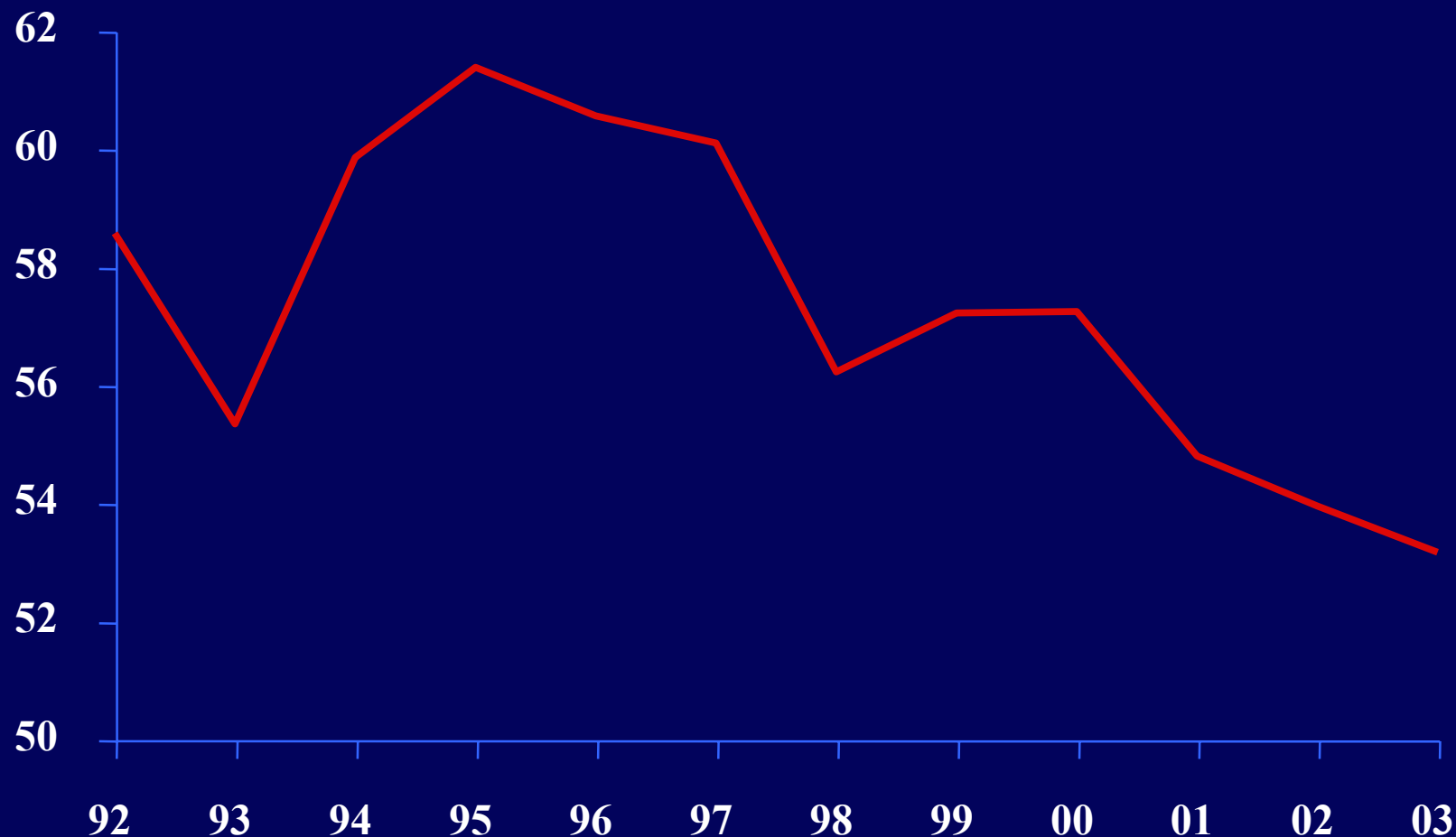


Where do we stand?

- Regarding the banking industry:
 - It has become more competitive and more efficient;
 - Foreign banks compete side to side with local banks;
 - There has been a reorganization in the industry through several mergers and acquisitions;
 - Chilean banks are among the soundest in the world.
- In addition, institutional investors have become increasingly important and have achieved greater portfolio diversification.
- As a result, today the Chilean capital market is one of the largest (relative to the economy size) among emerging market economies.

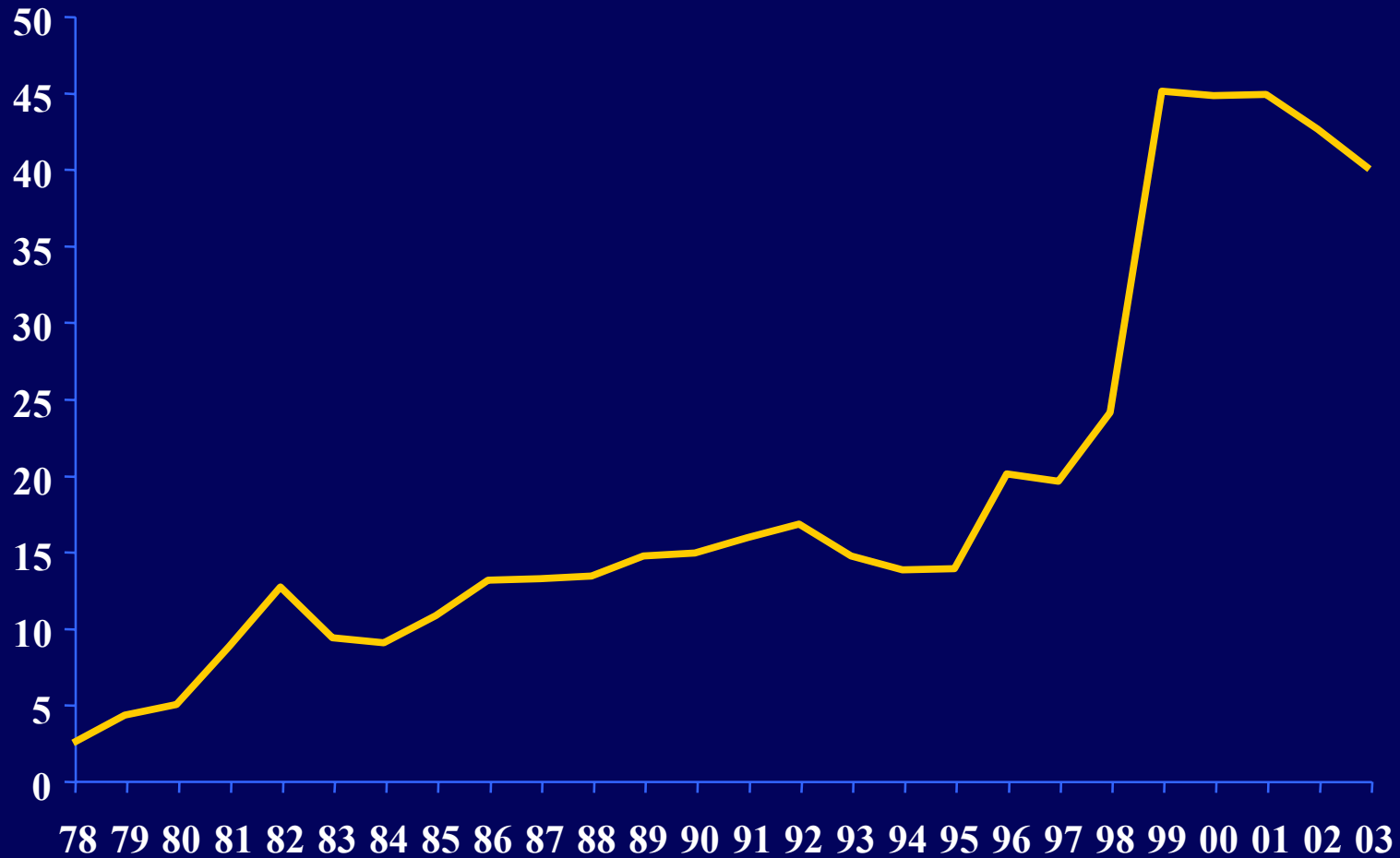
Banking Sector Non-Operational Expenses

(as % of Operational Margin 1992-2003)



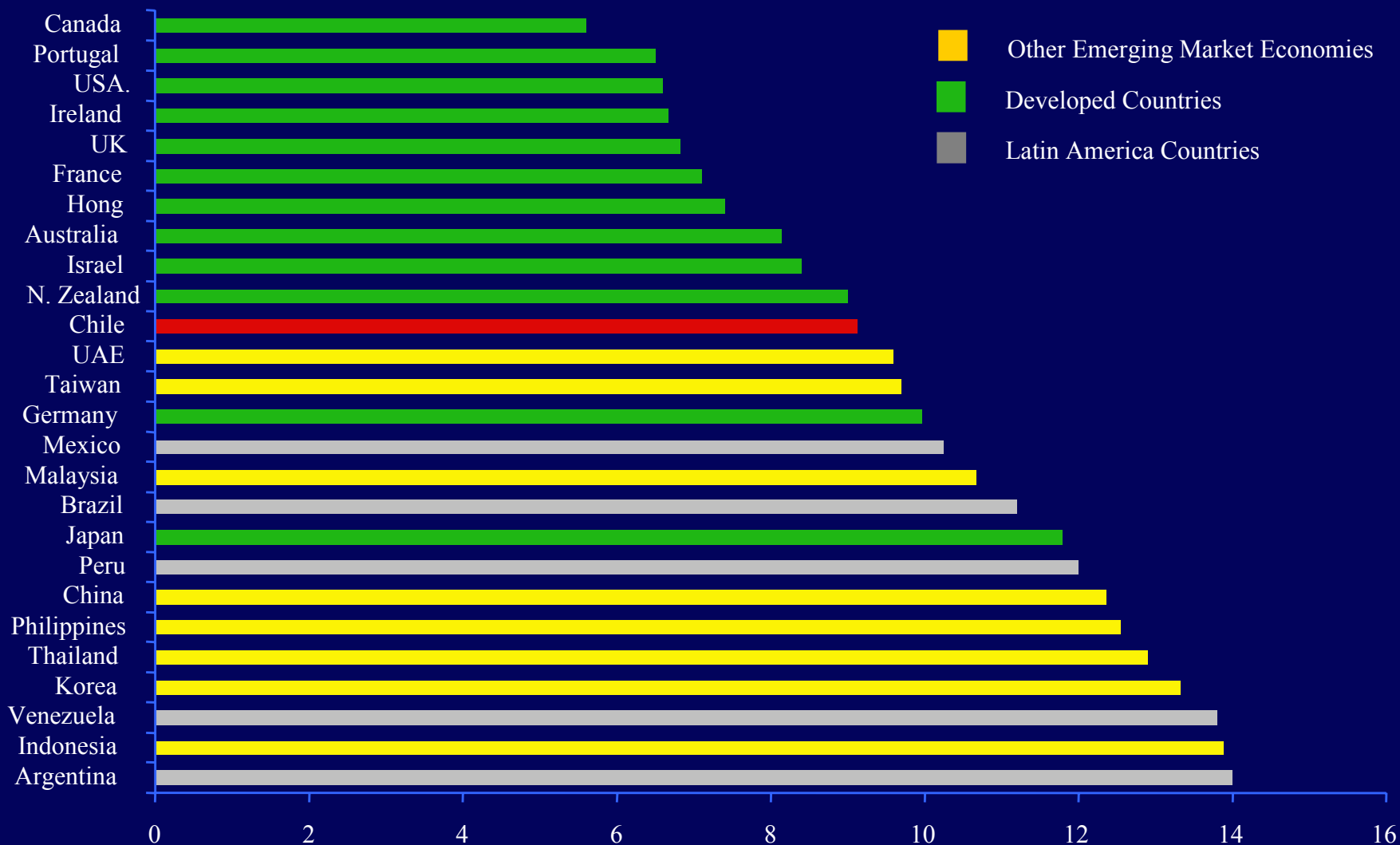
Source: SBIF

Foreign Banks Participation in Total Lending (%)



Source: SBIF

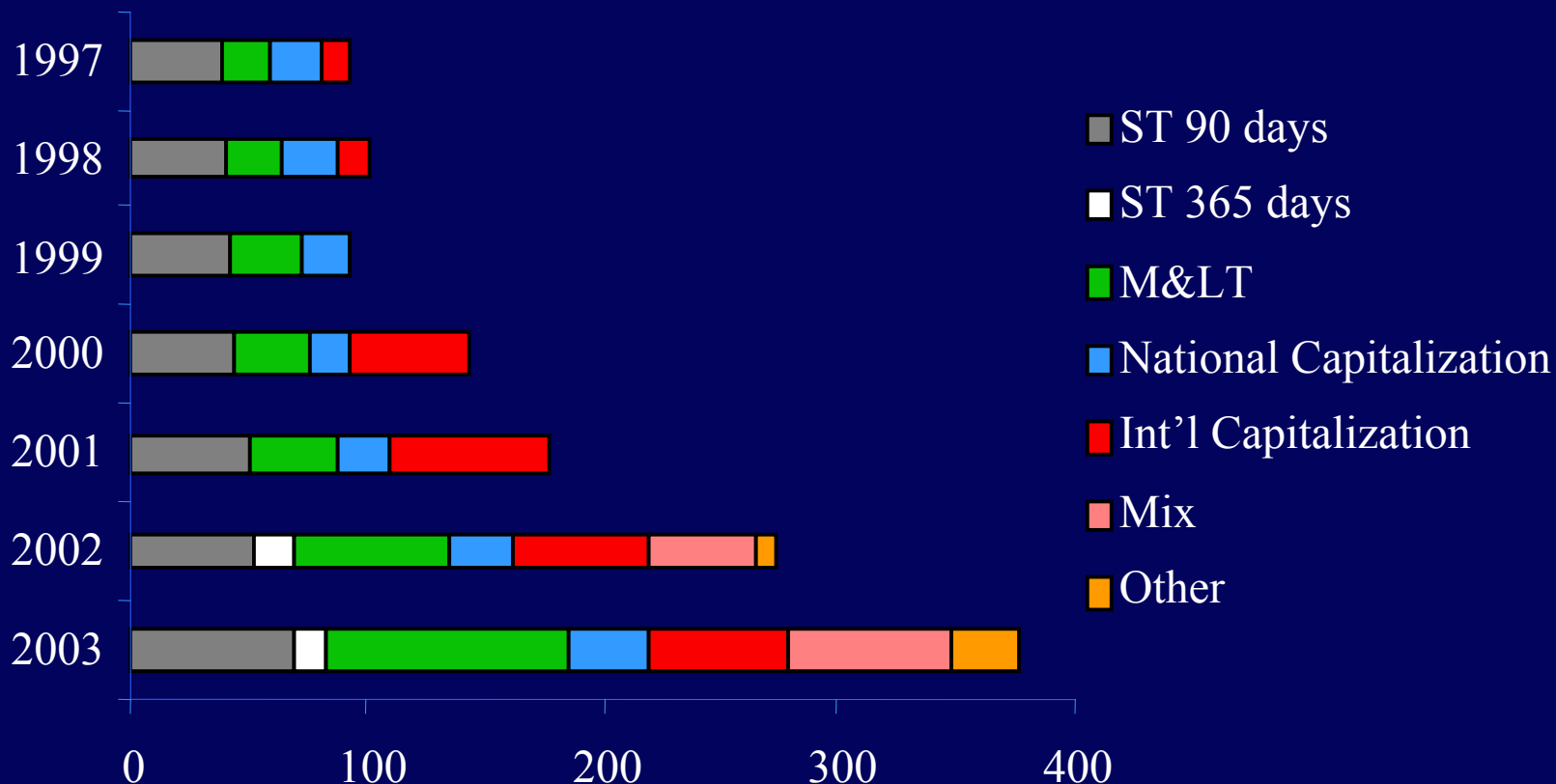
Ranking of Banking Strength



Source: Moody's, March 2003.

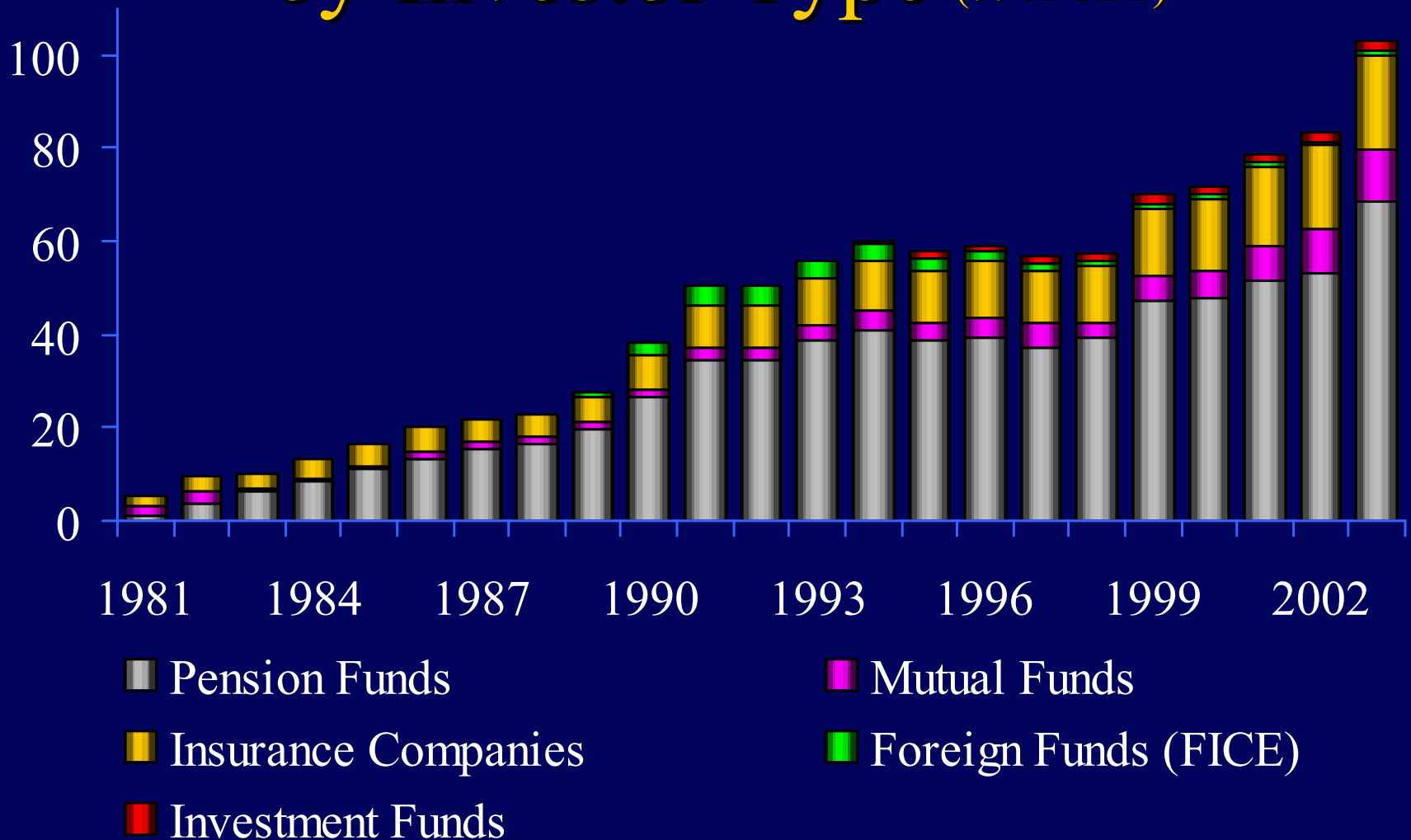
Mutual Funds Industry 1997-2003

(number of funds)



Source: AAFM

Institutional Investors: Total Assets by Investor Type (% of GDP)



Financial Development: Total Assets

(% of GDP, as of 2001)



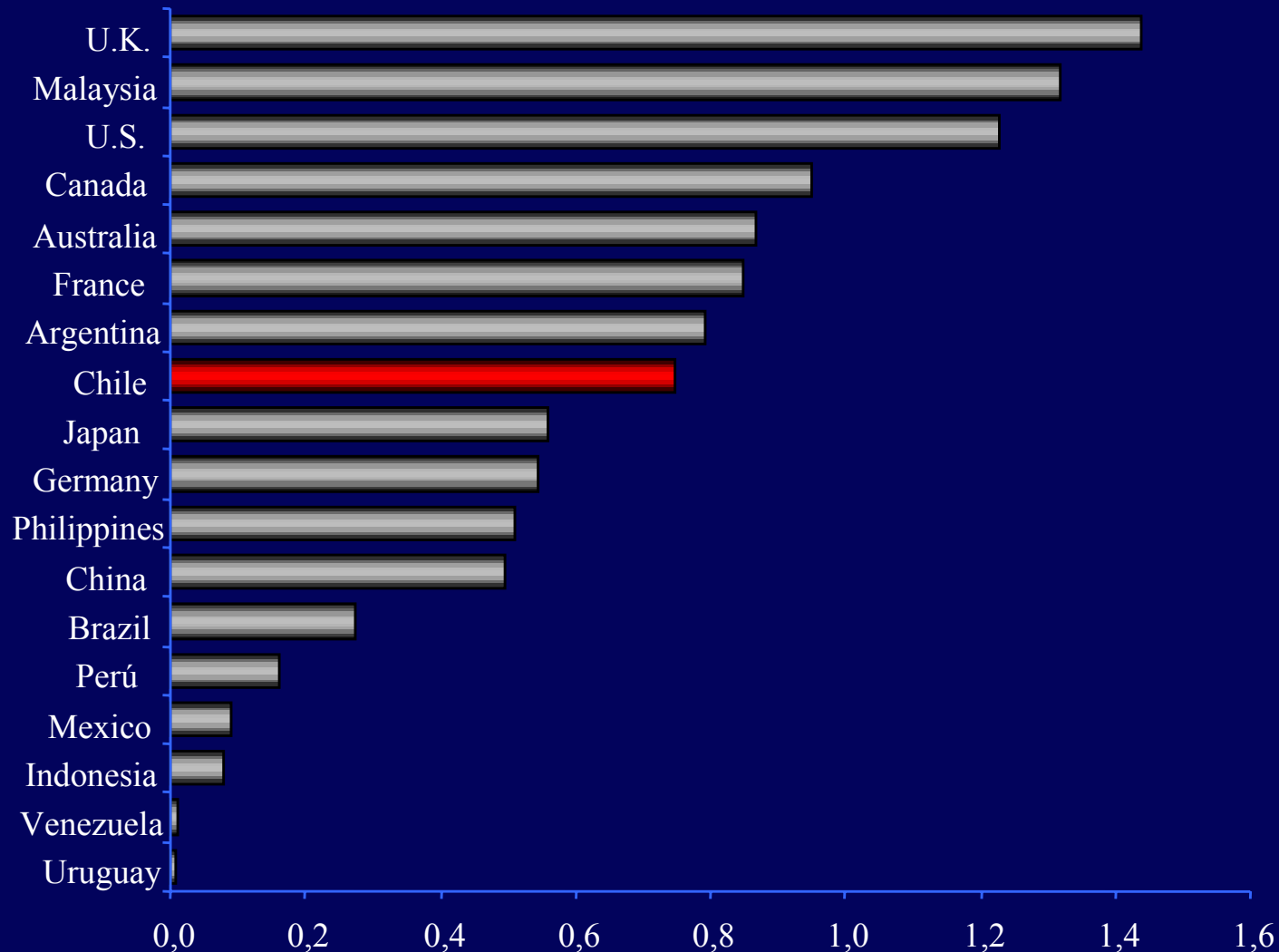
Comprises banks' liquid liabilities plus stock market capitalization plus private and public bonds market capitalization. Source: Beck, Demirguc-Kunt and Levine (2003).

Where do we stand?

- However, at the beginning of the 21st Century and despite sustained growth Chilean capital markets remain relatively unsophisticated.
- Development has been uneven by areas:
 - Relatively high capitalization but low liquidity in the stock market;
 - Very limited use of derivatives;
 - Complete lack of venture capital;
 - No consolidated supervision;
 - Large institutional investors and banks oriented mostly to traditional activities (i.e., funding of prime companies).

Stock Market Capitalization

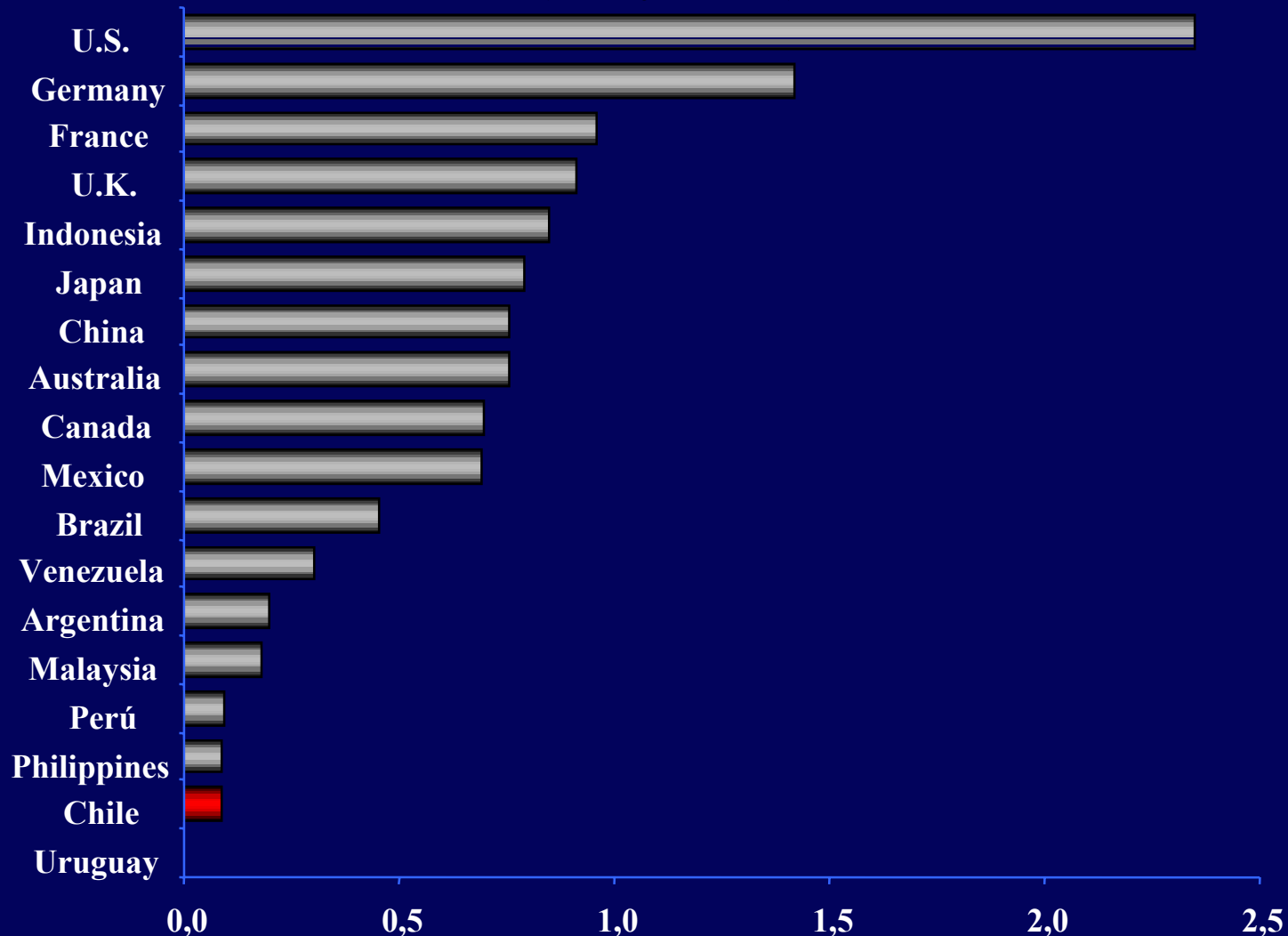
(% of GDP, as of 2001)



Source: Beck, Demirguc-Kunt and Levine (2003)

Stock Market Turnover Ratio

(as of 2001)



Source: Beck, Demirguc-Kunt and Levine (2003)

Where do we stand?

- The increasing integration of the Chilean economy requires an upgrade of the capital market infrastructure and the adoption of international standards and best practices.
- To take full advantage of the global economy we need to move forward in areas such as market regulation, cooperation and information sharing among regulatory agencies, consolidated supervision, improvement of financial contracts, etc.

III. Recent Developments and Remaining Challenges

Recent Developments

- Recent problems have triggered a revision/upgrade of micro aspects affecting the functioning of capital markets.
- The most important recent reforms in this area are:
 - Public Offerings and Corporate Governance Law
 - Capital Market Reforms (I and II)
 - Modernization of the Payment System

Recent Developments

- Public Offerings and Corporate Governance Law (2001):
 - Set regulations to protect minority shareholders;
 - Set obligations for companies' Board members and created an institution to oversee the company controller.
- Capital Markets Reform I (2001):
 - Provided tax benefits and deregulated insurance and mutual funds (among other measures) to foster capital markets development.

Recent Developments

- Capital Markets Reform II (under study):
 - Incentives for the development of the venture capital industry;
 - Tax incentives for funding emerging companies/pilot projects;
 - Refinement of the Corporate Governance Law;
 - Promotion of savings through 401K type accounts;
 - Improvement of market supervision through better coordination among agencies.

Recent Developments

- Modernization of the Payments System: Real Time Gross Settlement and Netting Schemes
 - Launch of the CB's new RTGS System for large-value and critical inter-bank payments, in full compliance with the BIS-CPSS Core Principles:
 - Increases safety and efficiency in the settlement of large payments, thus reducing systemic risk and contributing to overall financial stability.
- In addition, the CB issued regulations for a netting scheme for large value payments.

Future Challenges

- Improve SME access to credit and capital markets.
- Deepen local securities market (participation of foreign investors in the local market; greater use of interest rate derivatives; etc.).
- Improve services in retail banking: customers education, information and transparency.
- Enhance stock market liquidity.

Future Challenges

- Enhance resilience of domestic markets to financial turbulence:
 - Continue implementation of international standards and recommendations on best practices and regulations (Basle II, CPSS, IOSCO);
 - Strengthen coordination and cooperation among supervisory and regulatory agencies;
 - Attain greater risk diversification through internationalization and more intensive use of financial derivatives.

Future Challenges

- Develop a world-class infrastructure for financial markets operations:
 - Continue modernization and upgrading of securities trading and settlement platforms and systems;
 - Adopt true *Delivery versus Payment* (DVP) and *Payment versus Payment* (PVP) principles in major local securities markets.

