

“From Weakness to Strength: The Journey of the Chilean Financial System and its Next Steps”

ChileDay – September 10 and 11th, 2019 – London, England

Mario Marcel

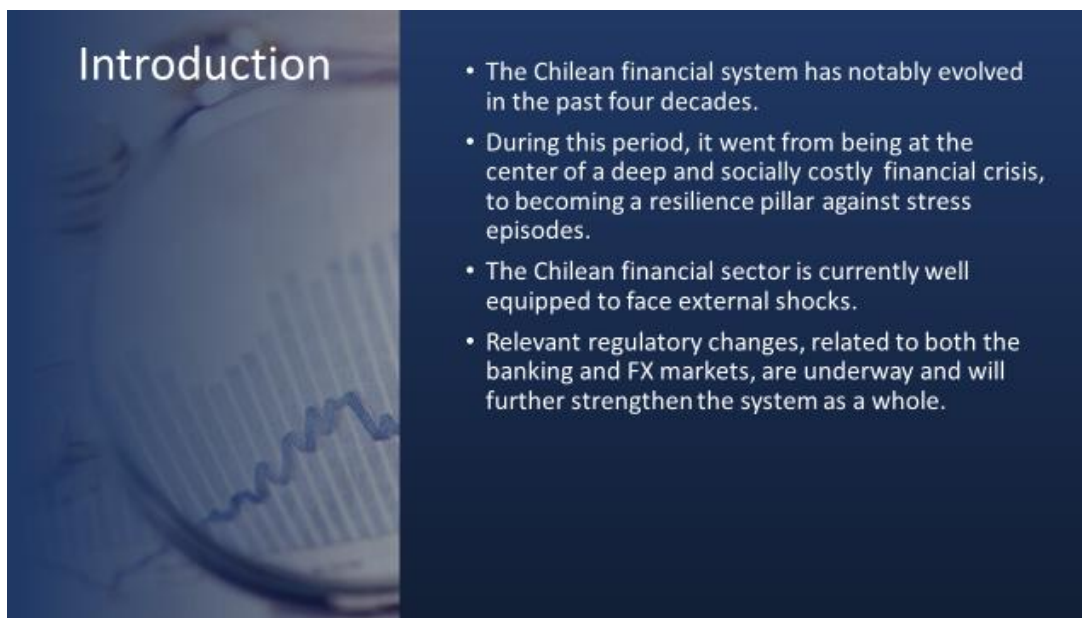
Governor of the Central Bank of Chile

The Chilean financial system has changed notably in the past four decades. While in the early 1980s it was at the center of one of the worse economic and social crises in history, now it is a major source of strength, providing resilience to the economy in the face of external shocks. So, how did this happen? What is the source of such resilience? What new challenges lie ahead? That is the purpose of this presentation.

In a nutshell, we can argue that the regulatory changes that followed the crisis set a new framework that, far from preventing financial development facilitated it in a way consistent with economic development. Some key reforms –most notably pension reform—facilitated the emergence of new actors, making the financial sector more diverse, deep and forward-looking.

Many pieces of evidence and tests in our semi-annual Financial Stability Report, have demonstrated over recent years that the Chilean financial sector is currently well equipped to face external shocks, providing key support to the flexible exchange rate regime by reducing the exposure of the business and financial sector to FX fluctuations. Similarly, the development of long-term capital markets secure local currency financing to investment projects and to the government itself.

The relationship between the financial sector and FX markets will indeed be an important part of this presentation as a connection between financial and macro stability. This is an important pillar for a small open economy like Chile, where the capital account was opened almost 20 years ago. This is, at the same time, an area where we can make additional progress, and I will share with you some of our immediate plans that combine well with the agenda that Minister Larraín has just presented.



Introduction

- The Chilean financial system has notably evolved in the past four decades.
- During this period, it went from being at the center of a deep and socially costly financial crisis, to becoming a resilience pillar against stress episodes.
- The Chilean financial sector is currently well equipped to face external shocks.
- Relevant regulatory changes, related to both the banking and FX markets, are underway and will further strengthen the system as a whole.

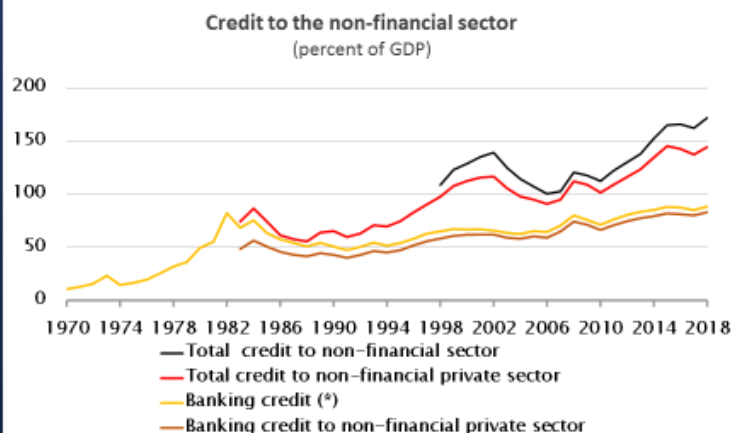


1 Evolution of the financial sector and banking regulation

Some 50 years ago, banks were almost the only source of financing for firms 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 with 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: it amplified these shocks leading the country into the deepest economic and financial crisis in a generation.

The Chilean financial system has evolved over the last four decades. Total credit went from representing less than 30% of GDP in 1978 to about 150% in 2018.



(*) Based on individual balances reported to the FMC.
Source: BIS and Martínez et al. (2018).

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Financial crises are abrupt, costly and protracted affairs, and the Chilean financial crisis of the early eighties was no exception. This crisis is often placed among the top 25 most severe financial crises in modern history.

In 1981, annual output growth went from positive 9% in the first quarter, 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 solvency. Banking profitability went quickly to negative territory and the delinquency rate quadrupled to 15% of the total portfolio, putting several banks at risk.

However, at the beginning of this process we went through a deep financial crisis, often quoted as one of the top 25 most severe in modern history.

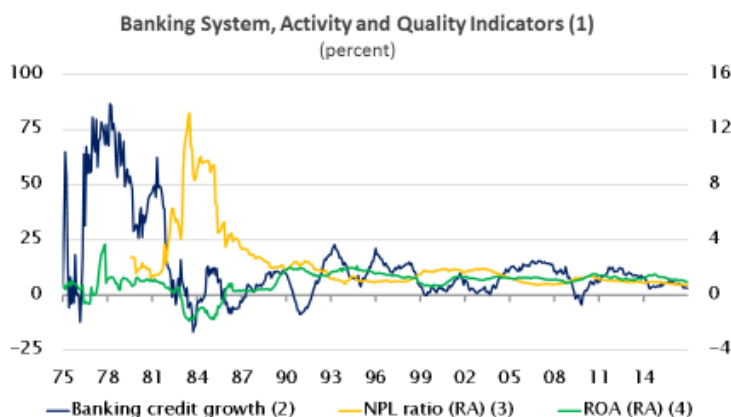
Biggest 25 Financial Crises						
Ranking	Year	Country	Annual growth	Number of years		
			Peak to trough	Peak to trough	Peak to recovery	Severity Index
1	1926	Chile	-47	3	16	62.6
3	1983	Peru	-32	11	25	57
4	1931	Uruguay	-36	3	17	53.1
6	1929	Mexico	-31	6	16	47.1
8	1890	Brazil	-22	4	21	42.7
10	1890	Uruguay	-21	2	19	40
14	1929/1933	USA	-29	4	10	38.6
12	1980/1985	Argentina	-22	11	18	39.8
15	1994	Venezuela	5	11	14	8.7
17	2008	Grece	-24	6	12	36
18	1931/1934	Argentina	-19	3	15	34.4
21	1981	Mexico	-14	7	17	31.1
23	2001	Argentina	-21	4	8	28.9
24	1980	Chile	-19	2	8	26.9
25	2002	Uruguay	-19	4	8	26.9

Source: Reinhart and Rogoff (2009).

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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.

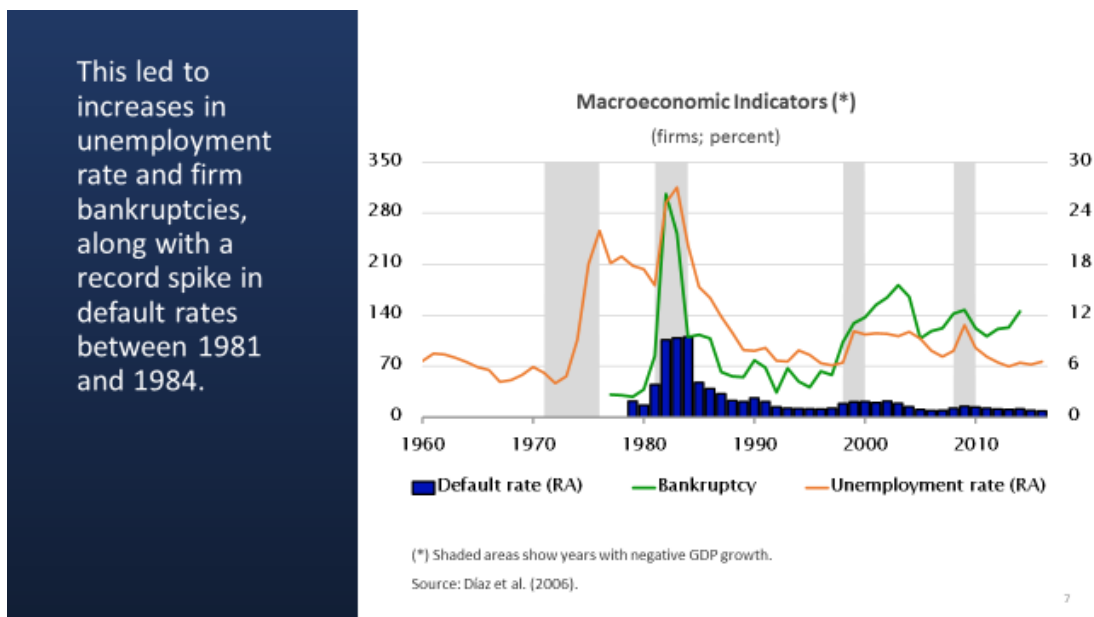
Several external factors contributed to the deterioration of the macroeconomic environment in 1982. Unsustainable debt was at the center, mostly explained by internal vulnerabilities.



(1) Financial information from FMC. (2) Real data converted through CPI until September 1979, and UF after that. (3) Percent of total credit (4) ROA considers annual revenues based on accumulated past 12 months. Source: Martínez et al. (2018).

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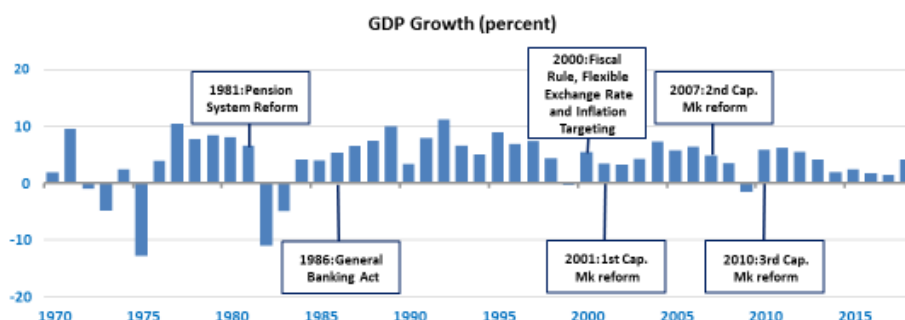
All these factors interacted with one another to become an outright banking crisis. Nevertheless, whatever the causes of the crisis, unsustainable debt was mostly explained by internal vulnerabilities: inappropriate regulation, weak supervision, and lack of attention to excessive credit growth, leveraged on a fixed exchange rate scheme.



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 be paid in kind instead of liquid resources. All of these elements were common practice before the 1982 crisis.

Paradoxically, what could be considered harsher regulation did not hamper financial deepening. Instead, it fostered a systematic buildup of solvency and credibility of the banking system and allowed its healthy development in the ensuing decades. Yet the 1986 Banking Law was hardly the only piece of the financial architecture that changed significantly. Notably, the creation of a funded pension system, and subsequent capital market reforms, together with capital market openness, dramatically changed the size, composition, depth, and strength of the financial sector in Chile.

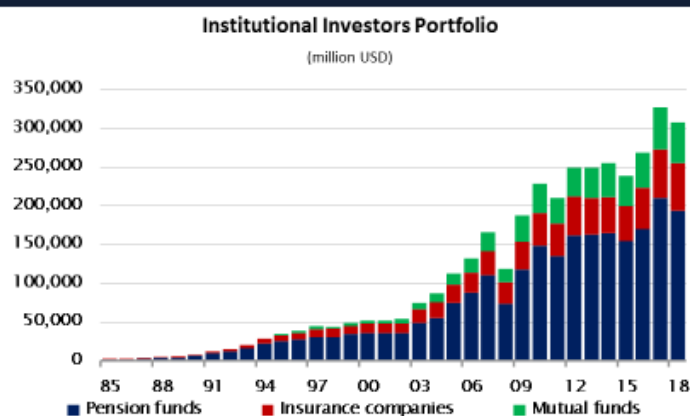
The lessons learned from this crisis highlighted the fact that banking regulation and supervision needed to be substantially upgraded.



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By funneling household savings into capital markets, Pension Funds were especially important in 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 (a currency unit indexed to inflation), 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.

The Pension System Reform greatly contributed to the early development of a deep debt market. Institutional Investors play a central role in it.



Source: FMC and SP.

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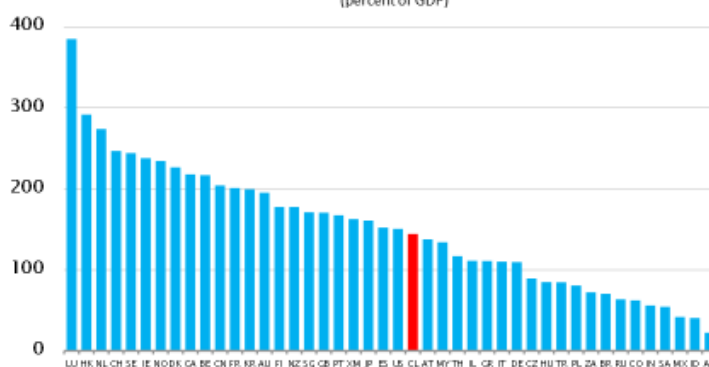
Over time, pension funds were allowed to invest abroad. This fostered profitability and diversification of pension funds, prevented distorting prices in the domestic financial sector, and created a two-way street for capital flows managed by domestic agents. As foreign assets of pension funds needed to be protected from FX risk, a hedging market also developed. This fit well with changes on the macroeconomic side. In the late 1990s Chile adopted a flexible exchange rate regime and liberalized capital flows.

All of these reforms led to developing the Chilean financial system in a sound way. Currently placing Chile near the median of a group of countries in terms of private indebtedness.

This financial development has placed Chile close to the median in terms of private indebtedness within a wide sample of countries.

Total Credit to Private Non-Financial Sector

(percent of GDP)



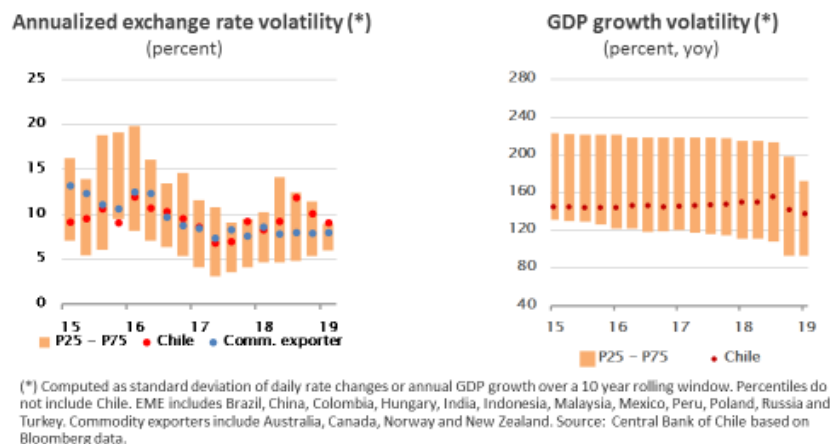
Source: BIS.

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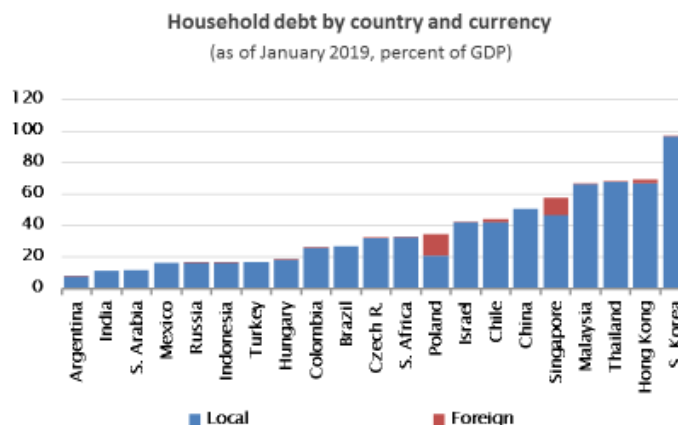
How does the Chilean financial market currently combine with the exchange rate regime? Under the flexible exchange regime adopted in 1999 and taking into account all the reforms mentioned above, it is not surprising that Chile has a relatively volatile currency. However, in terms of GDP growth we appear more stable than our peers.

Nowadays, under a flexible exchange rate regime, Chile has a relatively volatile currency. However, GDP growth is more stable than that of comparable economies.



This is due, in part, to the fact that households, the government and small businesses are not exposed to exchange rate risk, either because they do not borrow in foreign currency or because they hold a natural hedge. Paradoxically, given the openness of the capital account and free exchange rate, Chile is not a dollarized country at all. Banks and regulators, on the other hand learned well the lessons of the 1980s crises and FX exposure is central to risk assessment and prevention.

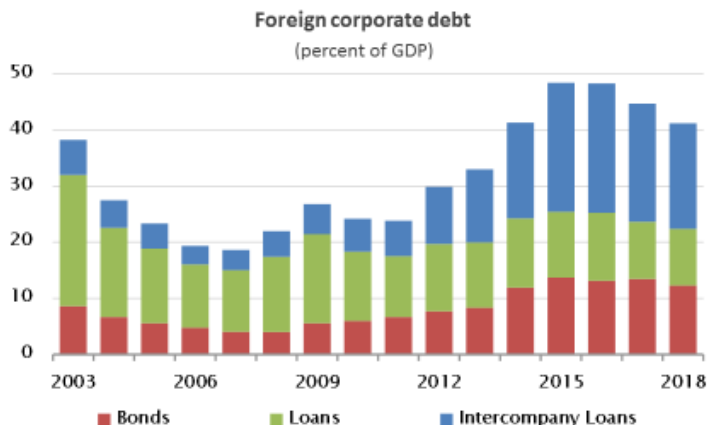
In terms of FX exposure, Chilean households hold a rather low share of their debt in foreign currencies compared to other Emerging economies.



Source: Institute of International Finance.

Larger companies, on the other hand, can draw on the openness of the economy and the prestige of local regulations to take advantage of the overseas bond market while avoiding undertaking FX risk. 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.

For firms, macroeconomic stability under a flexible exchange rate, together with regulatory changes, have fostered the development of overseas bond market local companies.

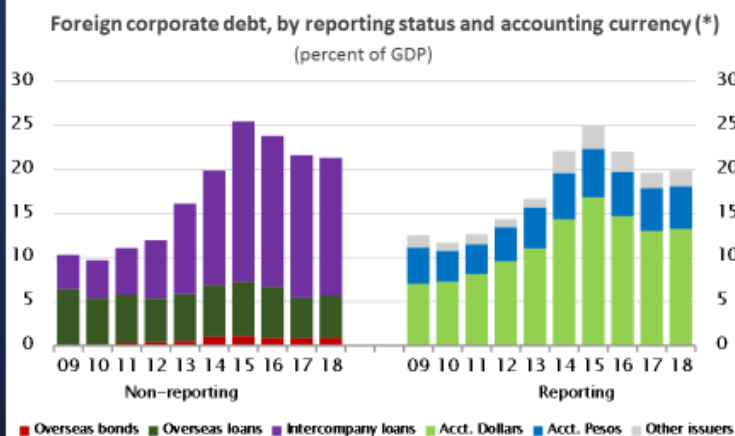


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Total external debt in dollars has been stable over the last few years, at around US\$120 billion. A substantial part of this reflects the growing internationalization of the Chilean corporate sector. A large share of that total is associated with foreign direct investment (FDI) on local subsidiaries of multinational corporations. To the extent that FDI represents a commitment between related companies, the enforceability of debt repayment and the associated financial conditions respond to different factors than in the case of debt with other institutions, which mitigates risk in the event of an increase in financing costs. Among firms that report to the FMC, two-thirds of external debt is concentrated among companies that use the U.S. dollar as their accounting currency, this share has been stable over the last decade.

However, the exposure to exchange rate has been limited in the corporate sector.

For reporting firms, most external debt is concentrated among those with U.S. dollar as accounting currency, which provides a natural hedge.

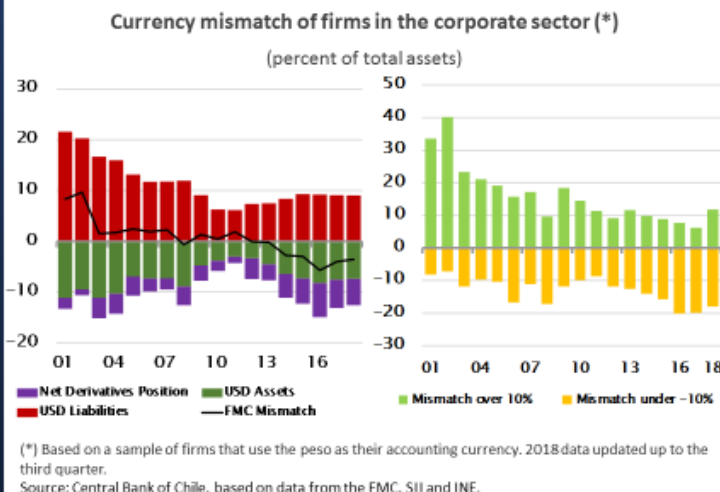


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Learning from previous episodes, the risks associated with external debt remain low, given the characteristics of the debt and an appropriate use of hedging by the firms. Among firms that report in pesos, the debt is mostly concentrated in those with a limited individual currency mismatch: firms with a mismatch

of over 10% of their assets hold just 3% of external debt, and represent about 10% of the total number of companies that use the Chilean peso as accounting currency.

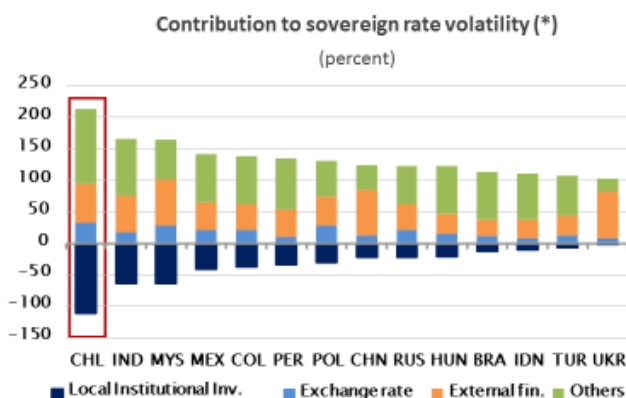
Among firms that report their balance sheets in Chilean peso, debt is mostly concentrated in companies with low individual currency mismatch.



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Local institutional investors' participation in the local sovereign debt market, especially in the longer segments of the yield curve, is much higher in Chile than in most emerging economies, at 80 to 90%. Thus, the buy-and-hold strategy of these investors reduces the volatility of both local sovereign rates and domestic funding costs.

Also, the high participation of local institutional investors in the local sovereign debt market, is an important buffer which may reduce the volatility of local sovereign rates.

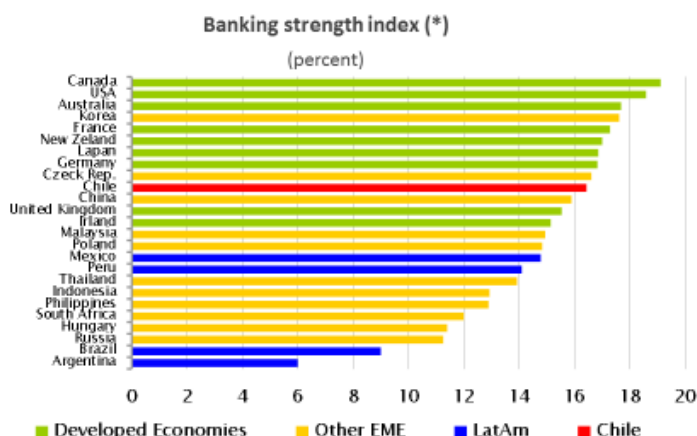


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By now, the Chilean financial sector is one of the most developed in the emerging world. It has transited from being largely dominated by traditional banking to being composed by several other market participants, including Pension Funds, General Fund 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 into improved access to alternative sources of funding by Chilean firms. Currently, around 85% of total corporate bonds are held by institutional investors, thus reliance on banking credit of these corporations has gone from 91% of financial debt in 1986 to around 25% in recent years.

Overall, the Chilean financial sector is among the most developed in the emerging world.



(*) Higher values imply banking strength.

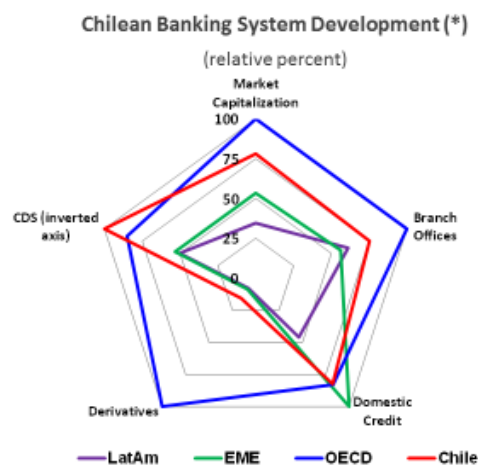
Source: Moody's Average Long-Term Ratings, April 16th 2019.

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Financial development has been important not only for firms but also for the country as a whole. 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.

And also shows better performance than those in other Latin American and Emerging economies.



Source: Moody's Average Long-Term Ratings, April 16th 2019 and Central Bank of Chile based on data from the BIS, WB, IMF and Bloomberg.

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The Chilean financial crisis of the early eighties led not only to a radical bank regulation revision, but also to learning valuable lessons for the future. A deeper and properly regulated financial system contributes to financial stability, inclusion and increased welfare. Even though significant progress has been made in this regard, there are still challenges ahead that must be faced to further strengthen our financial system.

Let me now address some of these regulatory challenges the CBC has been working on.

Significant progress has been made, but there are still challenges ahead...

- The Chilean financial crisis of the early eighties led not only to a radical bank regulation revision, but also to learning valuable lessons for the future.
- A deeper and properly regulated financial system contributes to financial stability, inclusion and increased welfare.
- Over this journey the Chilean financial system has become a resilience pillar during stress episodes. It is currently well equipped to face both local and external shocks.
- However, there are challenges ahead. These relate to modernization and further integrating with the rest of the world.



In order to have a deeper FX market and enhance resilience of the financial sector a number of measures are being taken by the Central Bank of Chile (CBC). The internationalization of the Chilean peso can enhance financial stability, by alleviating liquidity concerns during stress episodes and reducing counterparty risks, among other effects. All of these changes must be accompanied with more robust and developed financial infrastructures. Also, the wider cross-border usage of the Chilean peso improves our position as a financial center.

A presentation slide with a dark blue background. On the left, there is a circular icon with the number '3'. To its right, the text 'Regulatory challenges' is written in white. The background features a faint, light-colored line graph with multiple data series, showing fluctuations over time. The graph is partially obscured by the dark blue overlay.

The internationalization of the Chilean Peso can enhance the resiliency of the financial sector

- The wider cross-border usage of the Chilean Peso can increase liquidity in the local FX market.
- This could be an structural change that improves financial stability. However, it must be accompanied with more robust and developed financial market infrastructures.
- Also, when the local currency is more integrated with the rest of the world, the exchange rate is less dependent on specific situations in the local FX market.
- In addition, the domestic financial industry can benefit from greater activity.

Regarding concrete measures towards accomplishing these goals, the CBC is reviewing its FX regulation, in order to modernize and simplify it. In addition, a larger and more developed FX market should benefit from having access to more robust financial market infrastructures.

In order to do so, the CBC issued regulation and is implementing a Trade Repository for OTC derivatives, relying on its current faculties and in coordination with the Financial Market Commission.

Additionally, the CBC is working on an initiative that will allow its Real Time Gross Settlement (RTGS) payment system to settle US dollars large-value interbank transactions. These measures add to the future inclusion of the Chilean Peso as the first CLS-eligible currency in South America. This is a priority for the CBC, therefore we are working closely with the CLS Bank to materialize this in the next three years.

We believe these policy actions, as well as those announced by the Minister of Finance in order to promote Chile as a Regional Financial Center, should greatly contribute to a more resilient financial sector, wider cross-border use of the Chilean Peso and a greater participation of non-residents in our FX market.



The Central Bank is taking a number of measures to modernize and further integrate our financial market with the world

- The internationalization of the Chilean Peso (CLP), through a modernization and simplification of Central Bank's FX regulation
- More robust financial market infrastructures.
 - Foreign Exchange Payment System (RTGS in foreign currency)
 - Inclusion of the CLP in the CLS-Bank System
 - Trade Repository for Derivatives (SIID).
- These measures are consistent with and contribute towards the objectives of the government

- The Strategic Planning 2018-2022 of the CBC includes a thorough review of its FX regulation.

Current FX regulations require most FX transactions to be executed through the “Formal Exchange Market” —which is comprised by banks and some stockbrokers— and to be reported to the CBC. These two elements have remained largely unchanged since the capital account was opened 20 years ago.

Back then, re-imposing capital controls could not be ruled out, and that rationale underlies the somewhat cumbersome structure of the FX regulation. Currently, while capital controls are still part of the regulatory toolbox, re-imposing them could only be considered during an exceptional situation.

Therefore, the CBC has decided to streamline its FX regulations and reduce the burden of compliance to the private sector, whenever possible, without affecting the quality of the statistical information or the capacity to act in an extreme scenario.

The first part of this process, eliminating some of the existing reporting requirements, is about to be put out for public consultation.

The internationalization of the Chilean Peso (CLP), through a modernization and simplification of Central Bank's FX regulation.

- Since the capital account was opened, almost 20 years ago, the Central Bank's FX regulation has not been significantly changed.
- Currently, the FX regulation requires to conduct most transactions through the "Formal Exchange Market" (banks and major stock brokers) and report them to the Central Bank, which contributes to our statistics.
- The Central Bank has decided to streamline its FX regulation and reduce the burden of compliance to the private sector, without affecting the quality of the balance of payments and financial account statistics.
- **The first document for modernizing FX regulation will be put out for public consultation within the next weeks.**

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- Modernizing FX transactions goes beyond a review of existing reporting requirements and the structure of the regulation. It also considers the review of long-standing policy definitions. One of those definitions is the restrictive regulation in terms of the currency denomination of FX transactions.

The Central Bank's Law establishes that FX transactions cannot be denominated in CLP unless authorized by the Central Bank. This faculty has been used only exceptionally, as it was seen as a tool to prevent the circumvention of capital controls.

Consequently, for instance, residents cannot grant CLP denominated credits to non-residents (but they can do so in foreign currency). While this provision does not prevent transactions to occur, it adds transaction costs that may be preventing a wider cross-border use of the Chilean Peso.

The CBC has implemented a free-floating exchange rate regime, in which the possibility of capital controls is extremely exceptional and even if applied this measure might not be effective to prevent circumvention. Therefore the CBC is considering the extension of present transactions that are authorized to be denominated in Chilean Pesos (bonds issued in Chile by non-residents, and transaction of foreign securities), as well as the related conditions to that authorization. Such as providing information to the CBC.

This change of policy will be put out for public consultation by the end of this year.

The internationalization of the Chilean Peso (CLP), through a modernization and simplification of Central Bank's FX regulation.

- Long-standing policy definitions will also be reviewed.
- Central Bank's Law establishes that FX transactions cannot be denominated in CLP unless authorized by the Central Bank. This faculty has been used only exceptionally.
- Originally the goal of being restrictive was to prevent the circumvention of capital controls, a common policy tool until late 90s.
- The Central Bank has implemented a free-floating exchange rate regime, in which the possibility of capital controls is extremely exceptional and even if applied might not be effective to prevent circumvention.
- Additionally this restriction adds costs that might prevent a wider cross-border usage of the CLP.
- **The specific transactions that will be authorized to be denominated in CLP and the related conditions are being assessed and should be put out for public consultation by the end of this year.**

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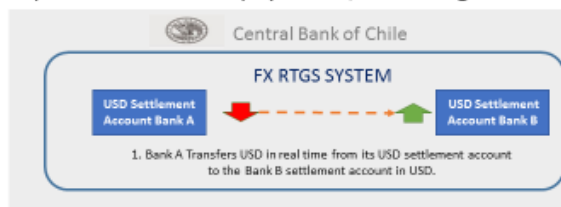
The Central Bank is developing a new regulatory framework that will allow the real time gross settlement (RTGS) of interbank payments in U.S. dollars, through the incorporation of this currency in the RTGS system managed and operated by the CBC.

The financial system's large-value payments in national currency are currently settled in the RTGS system, where payments are final and irrevocable in accordance with international practices. In contrast, foreign currency payments are settled through correspondent banks, a process that is not exempt from credit, operational, and liquidity risk. The requirements of the new regulatory framework were defined taking into account international experience and risk considerations, after which the draft regulations will be published for public consultation within the next weeks.

Dollar settlement at the CBC will improve the competitiveness of local infrastructures and promote the development of the financial market. Moreover, the implementation of this initiative will align local FMIs with international standards, which recommend settlement in RTGS systems due to their contribution to the risk management of participants, the functioning of the economy, and the preservation of financial stability.

Greater cross-border use of the CLP, and larger participation of non-residents in the local FX market require more robust financial market infrastructures.

- A more developed FX market should be accompanied by more developed financial market infrastructures.
- The Central Bank is adapting its large-value payment system (RTGS) so it can admit USD transactions. Next, in a second phase, it will develop a regulatory framework for a USD large-value clearinghouse.
- Therefore, foreign currency denominated payments between financial institutions will have similar clearing and settlement procedures as CLP payments, according to international standards.
- **The regulatory framework for a new RTGS-USD system will be put out for public consultation in the next weeks.**



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Another initiative that it is currently under development is the incorporation of the Chilean Peso to the *Continuous Linked Settlement System* (CLS). This financial market infrastructure is currently the international standard for the settlement of cross-currency payments because reduces the risk of settlement, also known as *Herstatt Risk*, to barely zero. Currently, 18 currencies are allowed to settle through CLS. The CBC along with CLS and the banking sector are working to make the CLP the 19th currency of this system.

In addition to acting in accordance with its financial stability mandate and contributing to the development of the Chilean financial sector, the promotion of this initiative further support the internationalization of the CLP.

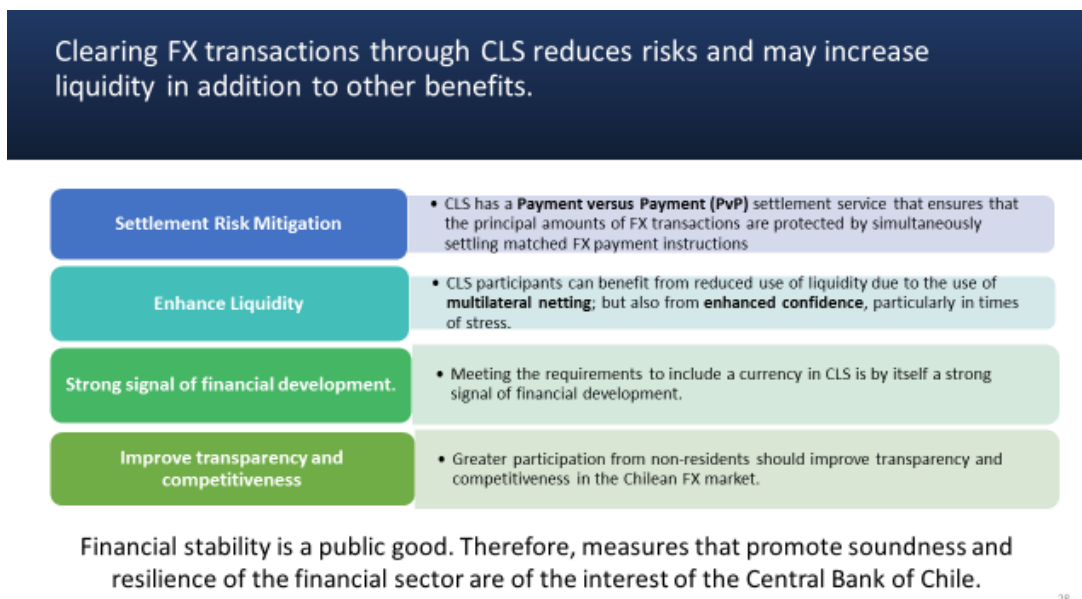
The Central Bank of Chile is working towards the inclusion of the CLP as the 19th CLS-eligible currency.

- By promoting the inclusion of the CLP as a CLS-eligible currency the Central Bank is acting in accordance with its mandate of preserving financial stability and contributing to the development of the Chilean financial sector.
- The Central Bank continuously monitors and adopts international standards and best practices applicable to payment systems.
- Regarding FX market payments, one global best practice is the use of CLS.

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The reduction of settlement risk of the FX transactions through a PvP settlement in CLS is just one of the benefits of the system. Moreover, CLS reduce the liquidity needs of its participants through the use of multilateral netting, and enhance confidence, particularly in times of financial stress.

From a more general perspective, a satisfactory CLS due diligence process along with a broad international participation trading in the CLP, will be a strong signal of the development and competitiveness of the Chilean financial markets.



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The process for the Chilean peso to become the first South American currency on CLS has started. Last July, we received the visit of CLS executives who had conversations with market participants and fruitful discussions at the CBC. After that visit, CLS and the CBC started the due diligence process. During this phase, the actions from the public and private sectors are essential.

Nevertheless, a successful process should not be over before the end of 2021.

The CBC is willing to take all the necessary measures to include the CLP into CLS, such as extending the opening hours of its RTGS system.

The CLP may be the first South American currency to join the CLS system.



- The process of including the CLP in the CLS system has started. A fruitful conclusion should not occur before 2021 → Actions from both, public and private sectors, are essential.
- The Central Bank is willing to take the necessary measures to include the CLP into CLS, such as extending the opening hours of its RTGS system.

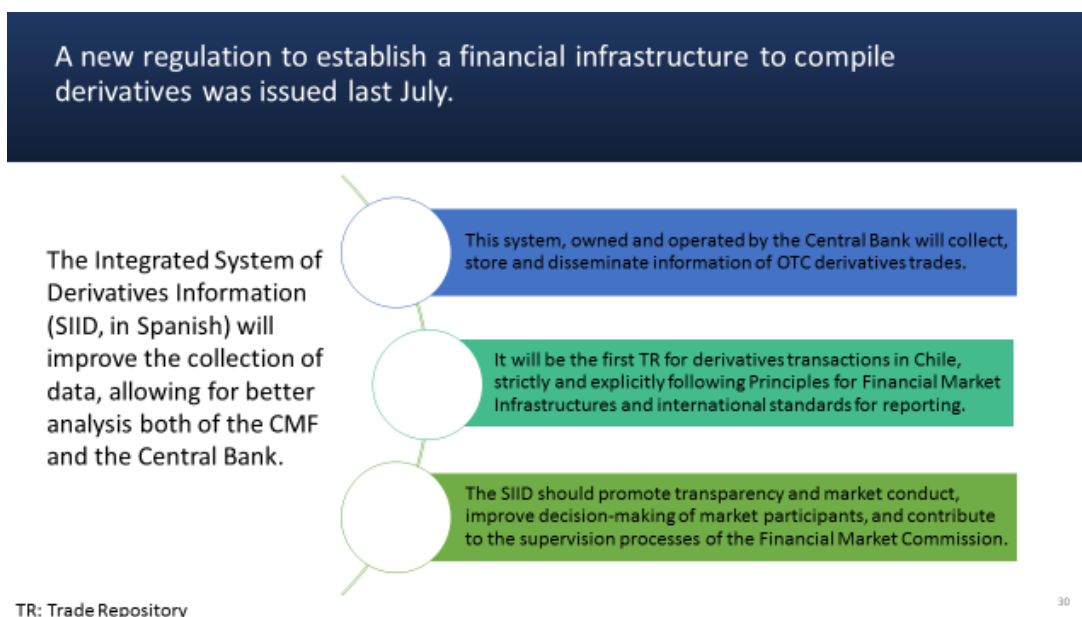
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Related to Financial Markets Infrastructures, I would like to mention that last June the CBC issued a new regulation framework which will implement the first Trade Repository (TR) of the country. This TR, called Integrated System of Derivatives Information (SIID, in Spanish), will be owned and operated by the central and, after a transition process, will be in full operation by 2021.

The SIID will collect, store and disseminate information of OTC derivatives trades, following the Principles for Financial Market Infrastructures (PFMIs) and international standards for reporting.

This infrastructure should promote transparency and market conduct, improve decision-making of market participants, and contribute to the supervision processes of the Financial Market Commission.

It is important to note that the Minister of Finance has just announced that a bill to regulate Trade Repositories will be sent to Congress. The SIID is perfectly compatible with the existence of private-owned trade repositories.



According to the latest BIS Triennial Review of foreign exchange and OTC derivatives, the Chilean Peso represents 0.2% of the global FX turnover. We strongly believe that this share should increase in the future.

The different developments that are underway should contribute to financial stability and increase the cross-border use of the CLP, as well as the participation of non-residents in the domestic market. Therefore, authorities and market participants should be prepared to be part of a bigger and more internationally integrated FX market.

The CLP currently represents 0.2% of the global FX markets. This should increase in the future.

- Many developments related to the FX market are simultaneously underway.
- The combination of these developments should contribute to increase the cross-border usage of the CLP, as well as participation of non-residents in the domestic market.
- In turn, this may change the traditional landscape of the Chilean FX market. Authorities and market participants will need to adapt to this new equilibrium.

Let me conclude by remarking that this journey for the Chilean financial system, through a deep financial crisis, has led to just new bank regulation but also to valuable lessons learnt for the future. A deeper and properly regulated financial system contributes to financial stability, inclusion and increased welfare.

Preventing stress episodes is a task that requires constant monitoring and early detection of potential sources of vulnerabilities and risk.

The enactment of a new Banking General Act and internationalization of the Chilean peso, among other measures, open up a new phase for modern regulation. Even though significant progress has been made in this regard, there are still challenges ahead that must be faced to further strengthen our financial system.



Final remarks

- Preventing stress episodes is a task that requires constant monitoring and early detection of potential sources of vulnerabilities and risk.
- The enactment of a new Banking General Act and internationalization of the Chilean peso, among other measures, open up a new phase for modern regulation.
- Even though significant progress has been made in this regard, there are still challenges ahead that must be faced to further strengthen our financial system.
