

SUPPLEMENTARY NOTE TO THE FINANCIAL STABILITY REPORT

Second Half 2019



INTRODUCTION

The *Financial Stability Report* (IEF) for the second half of 2019 was finalized a few days after the start of citizen protests that have extended all across the country. Consequently, the Board considered it necessary to prepare this supplementary note to provide background within the context of the *Report*.

In this regard, it is important to bear in mind that the primary objective of the FSR is to identify sources of risk to financial stability in Chile, together with vulnerability factors and the related mitigators, in order to provide or promote financial and economic policy responses that generate changes in the behavior of agents so as to minimize any residual risk that might persist.

The concern for financial stability emanates from the Bank's legal mandate to safeguard the continuity of the internal and external payment systems. From this perspective, it is clear that the Bank's concern is not confined to a particular industry, but rather encompasses the economy as a whole, since, as shown by both local and international experience, the discontinuity of payments can affect all economic agents, including nonfinancial firms and households.

This note analyzes under what conditions and through which channels the political and social turbulence could affect financial stability; how the recent events have affected the financial markets in Chile; what the stress tests suggest about the existing vulnerabilities and mitigators in the country; and what challenges arise for risk monitoring and analysis in the coming months.

RISKS DERIVING FROM THE INTERNAL TURBULENCE, VULNERABILITIES, AND MITIGATORS

The political and social context is an important factor in a country's financial stability. While news on political and social events is common, it primarily affects variables that are more sensitive to expectations, such as stock prices, and has limited impacts on other variables. However, when these situations become more entrenched and political uncertainty increases substantially, there can be a larger and more generalized effect. This is because the persistence of significant uncertainty ends up affecting variables that are more critical for market stability, the fulfillment of financial obligations, the availability of liquidity, and access to credit.

In particular, international experience suggests five channels through which this type of situation can be transmitted to the financial system:

- **Volatility of key prices:** The different agents could be exposed to sudden changes in the exchange rate or interest rates. In the case of both households and firms, movements in these prices can increase their financial burden if their debt is in foreign currency or is very short term (e.g., lines of credit). Lenders, in turn, can be exposed either directly or through the payment capacity of their customers. Thus, the impact will depend on exposure to the exchange rate and financial risk.
- **Output and employment:** A contraction in output and jobs makes it difficult for the different agents to meet their payment commitments, leading to an increase in default. This causes lenders to raise their lending standards, which increases the cost of financing and potentially leads to a tightening of the credit supply. This creates a cycle in which financing constraints reinforce payment problems.
- **Vulnerable sectors and the disruption of payments or credit:** Among the different economic agents, some groups are more economically vulnerable and thus could be more strongly affected by an adverse scenario, which could, in turn, have repercussions for other sectors. In the case of households, those that are more dependent on unstable income and that have a high financial burden could have trouble meeting their commitments in the face of lower economic activity. In the case of firms, the situation is similar. To the extent that they depend on credit or supplier payments to maintain their day-to-day operations, disruptions in the payment chain or in access to financing can create a complex situation for these sectors, potentially affecting other entities in the same payment chain.
- **Destruction of physical capital, collateral quality, or guarantees:** The destruction of physical capital has an impact not only in terms of capital replacement costs or the loss of productive capacity, but also through a reduction in the quality of the collateral used to guarantee financing. In some cases, the collateral is backed by insurance, but otherwise, the lack of insurance would imply an adjustment in financing conditions.
- **Change in risk perception, liquidity preference, and the supply of credit and other financial services:** In the face of heightened uncertainty, economic agents opt to increase their saving as a precautionary measure, while also increasing their preference for liquidity. This reduces the funds available to finance projects. It also affects the availability and cost of insurance, which could become harder to get and more expensive in a context of high risk and uncertainty.

FINANCIAL MARKET BEHAVIOR

In the two weeks since the start of the current social protests, the Chilean financial system has had to adjust to the circumstances in order to continue operating.

The payment systems have experienced minor disruptions. The interbank payment system operated by the Central Bank has adjusted its operating hours due to the situation, but there have been no disruptions in the processing of transactions. The Financial Market Commission reports that the financial system under its supervision has maintained operational continuity, indicating that other financial market infrastructures are also operating on shorter hours. Retail payment systems have been partially affected by the destruction of branches and automated teller machines (ATMs). However, the banks have taken measures to reopen offices and keep the available ATM network functioning. Electronic means have also functioned normally, including both bank websites and credit card payments.

With regard to the banking sector, to date there is evidence that the flow of commercial and consumer loans has slowed somewhat. With regard to bank liquidity, the liquidity coverage ratio (LCR) shows that these institutions have adequate liquidity levels to meet their liabilities. For the nonbank sector, updated information is not yet available.

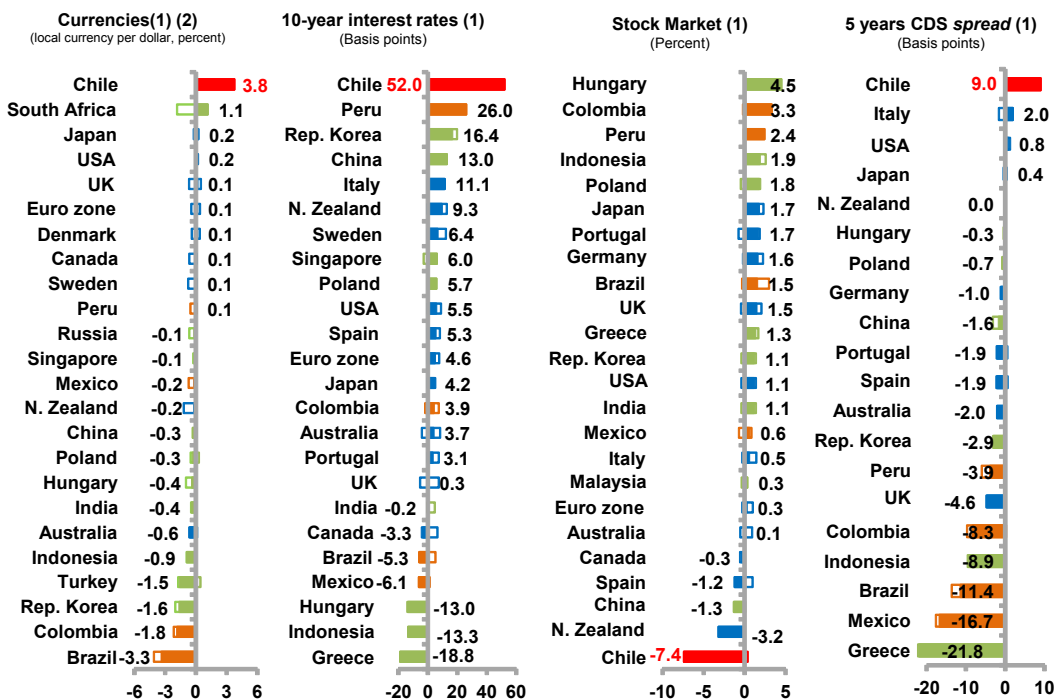
The response of the financial markets to the recent events has been varied (figure 1). Between 17 and 30 October, the five-year CDS rate for Chile increased 9 basis points. The cost of financing in pesos, measured as the 30-day deposit rate, decreased to 2.03%, supported by a reduction in the MPR at the October Monetary Policy Meeting. At the same time, the onshore spread was pushed upward in this

period, due to higher demand for foreign exchange in the spot market associated with expectations of a peso depreciation. Finally, long-term sovereign rates increased 52 basis points, in a scenario where pension fund affiliates have been migrating from type E funds (more intensive in local fixed-income securities) toward type A funds (more intensive in foreign variable-income securities) in recent days.

The Chilean peso depreciated 3.8%, while the IPSA fell 7.4%. Firms related to the retail, energy, and construction sectors recorded a 15% drop in stock market capitalization.

These movements occurred at a time when financial indicators for emerging countries have improved. For example, for countries in the region, CDS rates have fallen, stock markets have risen, and currencies have appreciated. This means that the deterioration in financial indicators, such as the exchange rate and the IPSA, is actually greater relative to what would have been the case under other circumstances.

FIGURE 1.
Financial indicators
(change from 17 to 30 October)



(1) Green bars correspond to emerging, orange to Latin America and blue to developed countries. Solid bars correspond to variation from Thursday 17-10-2019 and transparent bars to maximum and minimum changes. (2) Increase means depreciation.
Source: Bloomberg

The direction and magnitude of the shifts in these financial variables reflect an increase in the perception of uncertainty for the Chilean economy and a recognition that important sectors of the economy have been materially affected.

Thus, the stability of short-term funding costs in pesos depends on the banking system maintaining a solid position in terms of both liquidity and solvency and on the preservation of confidence in the current monetary and foreign exchange policies. The stress tests considered in this Report show that the banking sector is capable of facing a severe stress scenario.

STRESS TESTS

While the market movements of the last two weeks appear to be concentrated in certain markets, it is important to consider how significant the financial repercussions could be if the situation remains unresolved for some time.

Although the FSR has not traditionally analyzed risks deriving from domestic political and social turbulence, the stress tests still provide important information on the importance of the different transmission mechanisms and mitigation factors in Chile. Here, it is important to bear in mind that these tests aim to quantify the potential impact of the materialization of hypothetical economic scenarios on the solvency of the different agents.

Given that the financial markets in Chile have deepened over time, the different agents have been able to mitigate the impact of sudden changes in financial variables over the last several years. Households and firms have access to loans denominated in either pesos or UFs at different maturities, which allows them to finance their different projects. Thus, for example, the vast majority of mortgage loans are denominated in UFs and have maturities of around 20 years, with a fixed interest rate for the full period. This differs from other economies where this type of loan is given in foreign currency, at shorter maturities, or at a variable rate.

The most recent stress tests show that the financial situation of the different economic agents (firms, households, and banks) will allow them to face important changes in the main financial variables without compromising system stability, but that significant contractions in economic activity would be more difficult to manage. For example, in the case of households, a depreciation of the peso against the dollar would have a minor impact on their financial health, due to the limited holding of foreign currency debt, but an increase in the unemployment rate could cause a major disruption for families.

The direct impact of the recent demonstrations and protests is through lower sales for businesses. This could be especially critical for firms in the trade sector, which were already showing signs of financial vulnerability—namely, an increase in default indicators—as of the close of this *Report*. In this sense, the events in the second half of October could deteriorate these indicators even further due to lower sales, given that many stores either did not open or operated on shorter hours, while some firms took a hit in terms of their production capacity. The latter group includes large distributors, which will have an effect on their suppliers' demand. These trends could potentially affect workers' income.

CHALLENGES FOR FINANCIAL RISK MONITORING

The stress tests performed in this FSR, although calibrated for different scenarios, suggest that the domestic political and social turbulence could come to have a larger impact on financial stability if the negative effects on output and employment are more persistent. Greater volatility in the exchange rate and interest rates, in contrast, would have a more limited effect, given the low exposure of economic agents to this type of risk. However, specific sectors that are more financially vulnerable (e.g., households with a high debt burden or firms that rely extensively on credit lines) could have difficulty meeting their financial commitments in the face of an increase in interest rates under a scenario of low economic growth.

In this respect, in the communication following its October Monetary Policy Meeting, the Board mentioned that the recent events could result in lower economic activity in the short term due to the loss of infrastructure and lower sales. In the medium term, the evolution of output will largely depend on the magnitude and speed of the recovery of infrastructure, the evolution of expectations, and the effects of the policies that are formulated in response to the new scenario. This will therefore be a major focal point for the Central Bank, not only for the conduct of monetary policy, but also for the evaluation of the risks for financial stability.

Additionally, the particular characteristics of the recent events point to the need to closely monitor the behavior of the supply chain in industries that have been more affected by the destruction of infrastructure and loss of sales. Similarly, it will be important to evaluate the extent to which an increase in uncertainty could affect consumption and investment decisions.