SUMMARY

Since the last Financial Stability Report (FSR), the Chilean economy has continued facing the global health emergency effects and its repercussions over the markets. Global financial conditions have remained favorable but both political and economic uncertainty about the evolution of the pandemic remain high, which has translated into higher sensitivity of markets to unexpected events. The local financial market has endured a particularly challenging conjuncture, partly due to policymakers implementing exceptional measures to support lending, liquidity and risk management. Despite these measures, certain relevant risks still persist, mostly linked to a scenario where the real shock is more persistent than expected, to local events. Including changes to the legal framework that could hinder the functioning of financial markets, liquidity or solvency of financial institutions. Also, reduced equity among agents makes the more vulnerable when faced with scenarios of additional stress, this is due to increased liabilities, reduced assets, and diminished margins over the course of the past year. Thus, it becomes evident the need for an adequate balance between (i) maintaining favorable financial conditions; (ii) thorough monitoring and support to the financial system stability during stress episodes, and (iii) transitioning from restraining the impact of the crisis toward supporting the economic recovery.

Since the last Report, the global outlook has improved after a sudden drop in activity due to the Covid-19 health emergency, however, uncertainty persists due to the recent contagion resurgence. Although the coronavirus evolution has been heterogeneous among countries, its previous evolution permitted relaxing mobility restrictions in several jurisdictions. This translated into a more positive economic outlook with respect to the previous FSR. However, in recent weeks there has been a relevant coronavirus resurgence in the northern hemisphere, which has led to imposing restrictions, though not at the same level of stringency as seen before. The magnitude of the economic contraction has required maintaining, or even increasing, the wide array of macroeconomic and financial policies already in place, it cannot be ruled out that they will remain active if lockdowns persist.

In order to counter the effects of the pandemic several central banks implemented unprecedented liquidity provision measures which have maintained financial conditions favorable in global financial markets. The intensity of the policy reaction has contributed to maintaining low interest rates for sovereign bonds in both emerging and advanced economies. Nevertheless, financial markets remain volatile due to the uncertainty about the future evolution of the pandemic, the duration of the implemented measures, and the economic recovery outlook. The increased level of liquidity has boosted certain asset prices, e.g. stocks and commodities. However, there is high heterogeneity in funding costs among both countries and assets.

Moreover, the exceptional policy measures applied in Chile have helped mitigating the health emergency effects on the local financial market. In spite of the severity of the shock, the expansive stance of monetary policy, achieved through both conventional and unconventional measures, has contributed to maintaining favorable financial conditions. Among the unconventional measures, there is a purchase program for bank and Central Bank bonds (BCP and BCU) which has acquired securities that amount to US$13,500 million, there is also the Credit Conditional on Lending Increase (FCIC in Spanish) phases I and II, and the Liquidity Line of Credit (LCL in Spanish), both aimed toward strengthening bank lending amounting to about US$28,600 million. These measures have supported low funding costs, keeping bank and corporate bond issuance flows active. In this context, local long term sovereign rates have remained low, meanwhile bank and corporate spreads have declined since the last FSR.

In addition, the Central Bank of Chile (CBC) had to put into action special measures in order to prevent abrupt financial market corrections due to local events. In particular, the asset liquidation process carried out by pension funds in response to the massive withdrawals from individual capitalization accounts approved by the National Congress in July, could have significantly increased market volatility. However, this portfolio adjustment had a limited effect, partly due to the measures both the regulators and the CBC undertook, and also on account of the portfolio management strategy followed by the pension fund administrators. In specific, the utilization of the Spot Purchase with Term Sale facility (CCVP in Spanish) reached a maximum of US$5,550 million, which corresponds roughly to 35% of the withdrawals. Even though these measures successfully smoothed out the short term adjustment of financial markets, they do not compensate the long term effects of the reduced household savings on the current and future income of retirees and over the entire economy.

In the current conjuncture, households are faced with difficulties for generating income which have stressed their financial position and have thus required the implementation of exceptional policy actions. During the past few months, due to the lockdown measures and the deterioration of the labor market, households have experienced a significant income reduction. This adjustment has been mitigated by a wide array of policy measures, among which stand direct transfers and subsidies to low and medium income families and payment moratorium. Thus far these policies have prevented default from materializing. Nevertheless, families have had to reduce expenditures and use their savings, for instance by withdrawing from their pension funds through the exceptional approval of this mechanism. This policy deteriorated the financial position of savers, in exchange for short term liquidity.

The financial difficulties of the firms, due to operations interruptions, have been partially countered by debt issuance and special lending facilities. Since the previous FSR, the firms have increased their indebtedness reaching 134% of GDP as of the cutoff date of this report. An increased demand for credit, since the onset of the social protests in 2019, has been heightened during the first quarter because of the health emergency. Small firms have encountered a positive response from local banks to their funds requirements, in turn banks are more willing to lend due to the operation of policies fostering liquidity, collaterals and regulation flexibility, all of the above jointly implemented by the Ministry of Finance and the CBC. Larger firms have increased their banking leverage while maintaining access to the bond market, with a preference toward more liquid assets either for precautionary motives or low opportunity cost. In this way, lending support and capital market depth have helped preventing both the closing of firms and a deterioration of the bank loans portfolio. Even so, more than half of the increase in corporate debt to GDP can be attributed to the peso depreciation and economic downturn.

Despite the tension inherent to the scenario and operational contingencies, the payment and cash distribution systems have functioned with normality. Since the last report no relevant interruptions have affected the large value payment system, despite the operational restrictions posed by the lockdown and the increased flow of activities associated to measures in response to the pandemic. During the period one cybersecurity incident was recorded, it affected a local bank, and it led to the activation of the contingency tools of the Real Time Gross Settlement system (LBTR in Spanish) to prevent operational disruptions. Regarding cash distribution, there have been no relevant difficulties despite the large demand increase seen in recent months and motivated by mitigation measures and pension funds withdrawals. Nevertheless, both current and view account balances are well above their historic averages.

In this context, a slower than expected recovery is perceived as a relevant risk, as it could hamper the policy reaction effectivity. Several mitigation policies were originally designed as a financing bridge for temporarily facing a drop in liquidity and income. However, the health emergency has lasted more than expected, thus generating a more profound economic downturn and labor market deterioration. A slow recovery is therefore an important risk factor since, besides its direct effects on activity, it would limit the effectiveness of policies in action since the onset of the pandemic. This would increase the exposure of financial markets, debtors and lenders, triggering financial turbulence and insolvency.

Local elements inherent to the economy add to the aforementioned, associated with legal reforms that could have undesired effects during a particularly sensitive conjuncture. Disruptive events in the political and economic environment could affect financial institutions and/or amplify potential global risk appetite reversions. Events of this sort are not included in the usual stress test exercises and could unfold scenarios even more extreme than the ones typically considered. Changes to the legal framework require special attention, or inadequately calibrated regulatory requirements to financial institutions. Policy measures that affect the liquidity and solvency of lenders or institutional investors constitute an important risk, also pose a risk those initiatives that could compromise the flow of credit or the intermediation of resources between agents. Situations of this sort would limit the funding sources that those agents more affected by the health emergency require, particularly during the economic recovery phase.

Notwithstanding the contribution of the policy measures mitigating the effects of the pandemic, the maneuvering margins have tightened. Although the CBC has been able to act with efficacy in markets that have become more volatile, its margins of action could be smaller in those markets outside the regulatory perimeter or when faced with more permanent changes in investor portfolios. In particular, the CBC has instruments for attenuating transitory episodes of volatility, not for preventing the effects of structural or permanent changes. Meanwhile, the lending policies that have promoted low cost funding through special guaranteed have implied higher leverage, mainly among firms that fund themselves through local banks. This increases their vulnerability under sudden changes in the economic outlook.

Although an increase in lending has been essential to face the immediate impact of the pandemic, the higher leverage and lower capital margins make firms and lenders more vulnerable under more stressed scenarios. In a scenario with prolonged difficulties to generate income, liquidity problems can evolve into insolvency. The banking industry, although has been able to transit this emergency providing credit counter-cyclically, stepped into the pandemic with reduced capital margins with respect to previous episodes of distress and also with lower levels when compared with international peers. Loan moratorium does not eliminate credit risk, instead it defers the risk to the future. Thus, a prolongation of the health emergency would put additional pressure over the solvency and capital of the banking system. The exposure of banks to non-bank lenders, through commercial loans, remains a vulnerability provided non-banks usually exhibit higher risk credit and are highly exposed to agents relatively more affected by the economic downturn.

The policy reaction has required adapting the regulatory framework to face the health emergency and make room for facing future contingencies. The Executive and Congress have modified regulations and passed laws aimed to mitigate the negative effects of the economic downturn. Regarding laws, a miscellaneous project was enacted, it added flexibility to the issuance of convertible bonds in order to facilitate the funding of firms. Meanwhile, the CBC added new tools for improving its reaction during tension episodes. In this respect, the Flexible Line of Credit (LCL in Spanish) with the IMF, the funding lines with the Federal Reserve Bank of New York (FIMA) and with the People's Bank of China (PBoC), improve the liquidity management during stress scenarios in foreign exchange markets. Additionally, the constitutional reform that exceptionally allows the CBC to purchase Chilean sovereign bonds in secondary markets, enhances the flexibility of the CBC to face stress scenarios while preserving financial stability.

The financial authorities have continued to move forward on structural or long term initiatives. Regarding the CBC, this includes the modernization of its exchange market norms, the soon to be implemented Counter Cyclical Buffer (CCyB), and the improvements to financial market infrastructures which relate to the joint work with the banks and CLS to add the Chilean peso to this system. Likewise, the Financial Market Commission along with the CBC continue to move forward with the implementation of norms leading to the adoption Basel III within the framework of a new General Banking Act.

Moving forward, the necessity of continuous and sustainable access to credit, while maintaining a framework of management and evaluation of risks that preserves financial stability, puts forth the relevance and timeliness of recommendations this report has highlighted over the years. On the one hand, the lack of a consolidated debt registry remains to be a deficiency for the appropriate assessment of risks. Also, the use of collateral to hedge credit risk in the commercial portfolio constitutes a vulnerability, especially during events that affect the value of these guarantees. On the other, the effort to converge toward international solvency standards, by adapting the current banking regulation, is noteworthy. This includes aspects that refer to adjusting the dividends policy since they contribute to increase and improve the capital base, which in turn safeguards the system when faced with future contingencies.

Chile has a deep financial system, highly integrated with the rest of the world, as such it requires to strengthen its mitigation capabilities and to replenish the consumed financial margins. Local agents benefitted during many years of the improvements in external financial conditions without it increasing their financial risk levels, as shown in the Thematic Chapter in this report. However, the social protests initiated in 2019 and the health emergency have generated economic effects and policy responses that have reduced the financial margins that used to sustain this advantageous position. Toward the medium term, the main challenges relate to restoring these margins, such as a level of public debt coherent with income and expenditure flows, and an adequate capital level for the banks which is in line with the Basel III standards.

The safeguarding of a solid, credible and stable institutional framework is necessary for preserving the appropriate functioning of financial markets, which is imperative in the current context. As pointed out above, a deep financial system protects the economy from external disruptive events, while propitiating inclusion and welfare. In this conjuncture it is key having a resilient system due to the chance of a prolongation if the health emergency beyond current expectations, this scenario would delay the economic recovery and may require an extension of the mitigation policies past what was originally planned. In this sense, an institutional framework that maintains coordination between the branches of government, regulators, and supervisors, allows for adjustments in the body of rules that tend toward improved benefits for firms and families, while avoiding undesired side effects.