FINANCIAL STABILITY REPORT

FIRST HALF 2025

SUMMARY

The tariffs announced by the United States in early April —and subsequent developments— have considerably heightened uncertainty around the world. The unexpected magnitude of the announcements caused significant movements in financial asset prices and a substantial increase in volatility. Global financial markets have operated without major disruptions; however, risks to financial stability have increased markedly. At home, financial assets have also shown greater volatility, with trends that mirror those of other emerging economies. The Chilean economy has fixed the imbalances of previous years and the financial situation of borrowers —households and firms— has improved with respect to the previous report. Banks, in turn, have liquidity and capital levels that would allow them to withstand negative events. Thus, the deterioration of the global scenario finds the Chilean economy on a better position. A worsening of geopolitical and trade tensions represents the main risk for local financial stability, due to its impact on economic growth and deteriorating global financing conditions. Although the Chilean economy is not immune to these challenges, it has macroeconomic soundness and robust financial regulation and supervision standards in place, which provide adjustment mechanisms and buffers to mitigate the effects of adverse shocks.

EVOLUTION OF FINANCIAL MARKETS

Global economic uncertainty has increased considerably in the past few months. Since the publication of the previous Financial Stability Report (IEF) in November last year, there have been a series of developments in the political and commercial scene. The high point came at the beginning of April, when the US government announced much higher than expected tariffs on a broad set of countries. Additionally, the response from some of them was added. As a result, the index measuring trade uncertainty (TPU) almost doubled, hitting in April its highest in its recorded history, while financial volatility (measured by the VIX) rose to levels comparable to those at the outbreak of the pandemic. In addition, the string of announcements and counter-announcements have raised doubts about the magnitude and duration of the measures. Most recently, there have been some moves that have led to a better mood in the financial markets, but the scenario remains highly uncertain.

So far, the financial markets have been able to absorb these events smoothly enough, although the risks to global financial stability have increased significantly. The increased uncertainty has shaken the prices of financial assets and increased volatility around the world. It should be noted that the U.S. financial assets —long-term rates and the dollar— has not behaved as it used to in the face of events of global uncertainty, in which they tend to offer a safe haven. Trade tensions have increased in a context where other global vulnerabilities are still present. These include a high level of public and private debt in the world, doubts about the performance some Chinese industries and the unfolding of various geopolitical conflicts. This scenario has led to downward revisions in activity forecasts for various economies.

In emerging economies —Chile included—, financial markets have shown a favorable evolution compared to past stressful episodes. Although sovereign spreads rose in April, these rises were of a lesser magnitude than in past stress episodes, while sovereign interest rates have declined slightly, currencies have appreciated against the dollar and stock markets have yielded positive returns. The increase in volatility of long-term rates and the Chilean stock market has been lower than the average of the emerging world. By contrast, the peso/dollar parity has been more volatile, which is to be expected given its role as an adjustment variable during stressed periods.

SITUATION OF BORROWERS AND LENDERS

The Chilean economy has adjusted its macroeconomic imbalances of previous years. The current account deficit continued to narrow in recent quarters, in line with a recovery in domestic saving. This higher saving owes mainly to improved household and corporate income resulting from the better performance of domestic activity. Despite still high levels of inflation, its recent evolution and that of its main determinants reaffirm the convergence outlook contained in our March Monetary Policy Report (IPoM).

The downturn in the global scenario finds individuals and businesses in a financial position that has been improving for the last few quarters, which mitigates the risks to the system. This assessment is made in a context where the increase in income and savings, along with the reduction of short- and long-term rates, have improved the indicators of indebtedness and financial burdens. Consumer credit defaults have fallen and mortgage defaults have stabilized. Commercial delinquency remains high by historical standards, even though it has been decreasing across the board in the different economic sectors. Larger companies —which report to the Financial Market Commission (CMF)— show an increase in operating cash flow and liquidity close to their historical average. On an aggregate level, the firms' indebtedness stood at 112% of GDP at the end of 2024, down somewhat from the figure reported at mid last year. This result came from a higher level of output, which more than offset the increase in external debt in nominal terms, given the increase in the issuance of instruments abroad and the depreciation of the exchange rate.

Despite the favorable evolution of overall financial conditions, vulnerabilities persist in some specific groups. Bigger companies show a stronger recovery of their financial indicators (i.e., indebtedness, margins, and financial burden) in contrast to the persistent lag of smaller firms, those that received Fogape loans during the pandemic, and those in the construction and real estate sectors.

The weakness in the residential real estate sector has persisted. The main factors that have affected this sector have remained, including the level of mortgage rates, low demand, and a high stock of finished homes. Thus, the slack provided by a stock of unfinished homes, which helped the companies to cope with the drop in sales, has been running out. Housing prices have shown a slight increase. As noted in previous reports, a significant downward adjustment continues to be a risk factor. However, in the face of a stress scenario, such as an abrupt adjustment in valued collateral, banks have sufficient mitigators in terms of debt-to-collateral ratios and conservative collateral valuation criteria (Box II.1, IEF second half 2024). In any case, at the margin, the sector has seen incipient positive signs, such as a good performance in the stock market valuation; lower commercial lending rates; and stabilized default rates among the firms, albeit at high levels.

The persistence of structural deficits for several years has been eroding fiscal slack and has increased public debt. Official projections indicate that in the short term, public debt would be slightly below the 45% of GDP limit defined as prudent by the authority. However, as noted in previous reports, there are risks that could lead to the debt exceeding this level in the coming years. Sustaining the debt below the defined threshold requires a strict set of measures and agreements. This poses an important challenge in which all stakeholders must compete. Maintaining prudent fiscal accounts through sustainable sovereign indebtedness is essential for the economy's ability to mitigate the impact of future shocks and improve the financing situation of households and businesses.

The banking system is further adapting to the full implementation of Basel III and appears to be well prepared to face a more negative scenario. The banks have built up sufficient provisions and collateral to cover the level of default in their portfolios and show slack in their liquidity indicators. The banking sector has continued to strengthen its capital base and its solvency indicators have grown in line with the process of convergence to Basel III standards. Since our last IEF, this has been done mainly through new issues of perpetual bonds. Its profitability has remained above historical averages.

Since the previous report, lending activity presents no big changes, associated with still sluggish demand and stable supply conditions, as shown by our first-quarter Bank Lending Survey. Consistently, the firms surveyed in the May Business Perceptions Survey report an easing of lending conditions, but with prospects that are still low in terms of their own demand for financing. Credit interest rates have continued to evolve in line with their benchmarks.

MAIN RISKS

The biggest risk for domestic financial stability stems from the external scenario, particularly a new resurgence of trade and geopolitical tensions. In a context where the valuation of external financial assets remains elevated, the risk of further price repricing is still present. An abrupt adjustment in global risk appetite could generate a correction in asset prices, thus worsening financial conditions for emerging economies. In such a scenario, a significant increase in sovereign spreads and sudden capital outflows could be observed, with consequences for agents' liquidity, borrowing capacity, and solvency. This is especially relevant in emerging economies with weaker fiscal and external buffers (GFSR, April 2025). Locally, the shallower financial market as compared with previous episodes could erode the country's capacity to cushion the effects on financial variables of abrupt changes in portfolios.

International tensions may have a negative local impact on both economic activity and the payment capacity of households and firms. Although certain positive developments have been observed in recent weeks, the magnitude of the effects that trade tensions and increased uncertainty will have on the Chilean economy remains unclear. Thus, scenarios where these effects are significant cannot be ruled out, negatively impacting activity, the labor market and wealth, affecting the payment capacity of households and firms. These repercussions may be greater if commercial and geopolitical tensions intensify.

The Chilean economy has adjusted its imbalances of previous years, allowing households and firms to better deal with a deteriorated economic scenario. Compared to the previous IEF, under stress scenarios, debt-at-risk decreases in firms, mainly due to the better initial default situation of the trade sector. For individuals, debt-at-risk is mostly unchanged compared to the previous exercise. Incoming data suggests that the debt-at-risk of credit users continued to decline this year to date.

Stress tests yield that the local banking industry remains solvent to face a severe shock. In such a scenario, where activity contracts abruptly, funding costs escalate and financial conditions deteriorate, the banking system's capital level would allow it to absorb the potential losses. The availability of additional capital buffers, to which the issuance of perpetual bonds and the construction of regulatory buffers have contributed, has strengthened its capacity to absorb shocks in times of financial stress. In such scenarios, considering the most stringent capital metric (CET1), the banking system also remains solvent, with some banks of varying sizes making partial use of the regulatory buffer established for these purposes.

Despite having mitigators in place, the local financial system is not immune to the effects of a global shock. A deep capital market allows mitigating the effects of exposure to global markets, especially in the face of sudden reversals in financial prices. For this reason, it is necessary to continue efforts to deepen the local financial market. The pension reform will contribute to increasing household savings. However, it will take a long period for its effects to be reflected in a deeper capital market. Along the same lines, restoring fiscal slack will help generate fiscal slack to address shocks and strengthen the financial position of local agents, through access to lower-cost domestic and external funding.

The institutional framework that governs the Chilean economy, which includes macroeconomic soundness and robust financial regulation and supervision standards, allows having the necessary buffers and tools to mitigate the effects of adverse shocks. Our robust banking regulation and supervision framework, in line with international standards, stands out. This makes it possible for banks to have solid liquidity and capital positions, with adjustment mechanisms and buffers to face adverse shocks. In addition, the institutional framework contemplates a series of tools to be used in exceptional situations —which have been complemented with new powers incorporated in the Resilience Law— and coordination instances between the branches of government, the regulators, and the supervisors.

FINANCIAL POLICY DEVELOPMENTS

The implementation of macro prudential policies, such as the Countercyclical Capital Buffer activated in May 2023, reinforces the resilience of the banking industry and helps safeguard the stability of the overall financial system by supporting the provision of credit. The Board has decided to maintain the Countercyclical Capital Buffer (CCyB) at its current level of 0.5% of risk-weighted assets (RWA), consistent with the macrofinancial conditions and risks faced by the financial system, as described in this Report. This risk environment highlights the importance of having a pre-established capital buffer by the banks, which increases their capacity to withstand shocks and can be released in the event of a financial stress event, helping to mitigate its impacts on the provision of credit to households and businesses. As communicated in November 2024, the first Financial Policy Meeting of 2026 will evaluate the start of the convergence towards the neutral level of 1% of RWA, as long as macrofinancial conditions allow, and considering a period of at least one year for its construction.

With respect to the Central Bank's financial regulation agenda, this report outlines the priority initiatives for 2025, which focus on the implementation of the Resilience Law. During the first half of this year, a new regulation will be published for consultation that will allow the recognition of framework agreements and special conditions for Repo transactions. This initiative should contribute to the development of this market and thereby support the liquidity provision and management of financial institutions. For the second half of the year, priority will be given to initiatives related to the liquidity management of Central Counterparties, and to the access of certain non-bank entities to the RTGS system.

Among other financial policy developments, it is worth noting the changes associated with the implementation of the pension reform. Considering the volume of pension funds (roughly 60% of GDP), an important challenge is to enforce the new regulatory framework while avoiding undesired effects on the valuation and volatility of financial assets. In this sense, the implementation process of the following innovations is worth mentioning: biannual bids for affiliates; the entry of new players to the industry; and the replacement of the current Multifunds by Generational Funds. However, the approved legal framework contemplates a gradual transition to allow for the necessary adaptations.

FINANCIAL STABILITY REPORT / **First half 2025**