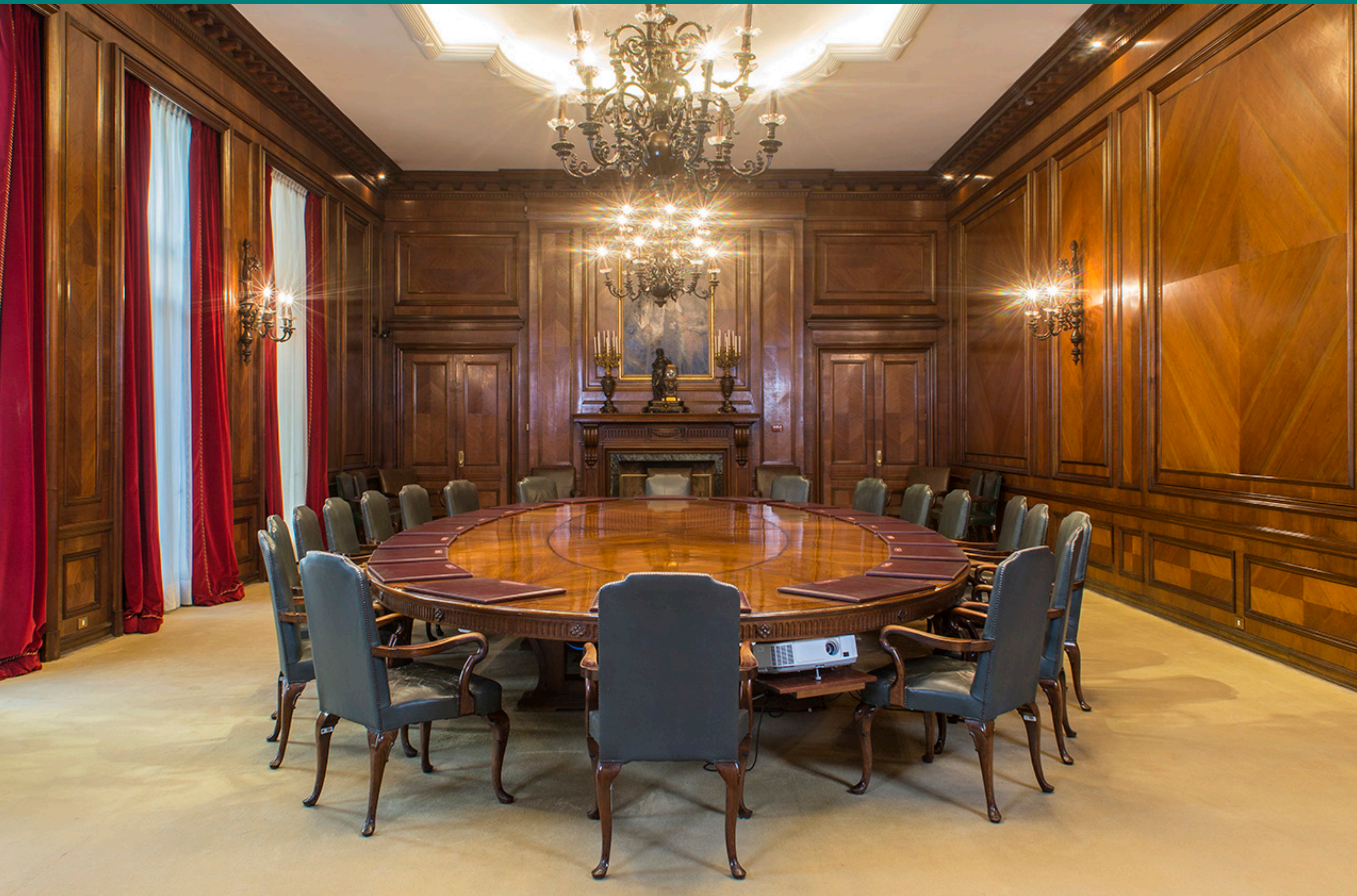
FINANCIAL POLICY MEETING

MAY 2025



FINANCIAL POLICY MEETING

Financial policy session No. 7, held on 15-16 May 2025.

Present: Rosanna Costa, Governor; Stepanka Novy, Vice-Governor; Alberto Naudon, Board member; Luis Felipe Céspedes, Board member; Claudio Soto, Board member.

Also present: Luis Óscar Herrera, General Manager; Juan Pablo Araya, Legal Counsel and Attestor; Rosario Celedón, Financial Policy Division Director; Elías Albagli, Monetary Policy Division Director; Ricardo Consiglio, Financial Markets Division Director; Gloria Peña, Statistics and Data Division Director; Michel Moure, Institutional Affairs Division Director; Miguel Fuentes, Financial Stability Manager; Gabriel Aparici, Financial Infrastructure and Regulation Manager; Mauricio Calani, acting Financial Research Manager; Markus Kirchner, Macroeconomic Analysis Manager; Guillermo Carlomagno, International Analysis Manager; Enrique Orellana, Monetary Policy Strategy and Communication; Sofía Bauducco, Economic Research Manager; Felipe Musa, Market Operations and Strategies Manager; Beltrán de Ramón, Commissioner of the Financial Market Commission; Alfredo Pistelli, Risk Analysis Director if said Commission; Alejandro Puente, Advisor to the Finance Minister; Andrés Alegría, Head of the Financial Analysis Department; Marlys Pabst, Secretary General.

1. Background

a. The international scenario

Global economic uncertainty had grown considerably, following the US government's tariff announcements and the response of some countries. The unexpected magnitude of the announcements had caused significant movements in financial asset prices and increases in global volatility. The financial markets had managed to absorb these events without major disruptions in their functioning. Worth noting was that the reaction of long-term interest rates and the U.S. dollar had not been the usual response to past events of global uncertainty. Although incoming information had shown some positive developments, which had led to an improve in market sentiment, there was still uncertainty regarding the impact of trade tensions and their effects on the global and local economy.

The escalation of trade tensions occurred in a context in which global vulnerabilities, such as high levels of public and private debt, were still latent, keeping long-term interest rates and their expectations high. At the same time, the structural vulnerabilities in the Chinese economy, highlighted in previous financial stability reports (IEFs), persisted, as did the unfolding of several sources of geopolitical conflicts. All this had led to downward corrections in the activity outlook for several economies.

In emerging economies —Chile included—, the financial markets had evolved favorably compared with previous stress episodes. Although the sovereign spreads of emerging markets had increased in April, these increases were of a lesser magnitude; and while sovereign interest rates had fallen slightly, currencies had appreciated against the dollar and stock markets showed positive yields.

b. The local scenario

Locally, the macroeconomic imbalances of previous years had been corrected and the financial conditions of households and firms had improved with respect to the previous financial policy meeting (FPM).

Given the heightened global uncertainty, local financial assets showed similar trends to those of other emerging economies. After the tariff announcements, the volatility of long-term rates and of the Chilean stock market had increased, although less than the average of emerging economies. The peso/dollar parity, conversely, had shown greater volatility, which was expected given its role as an adjustment variable in the event of episodes of tension.

In turn, the financial position of households and firms had improved in recent quarters, which reduced the risks to the system. This assessment was made in a context where the increase in income and savings, together with the reduction in short and long-term rates, had stabilized indebtedness and led to a decrease in financial burden. Delinquency rates of consumer loans had declined and the rise in mortgage loans had moderated. At the same time, commercial delinquency rate remained high from a historical perspective, despite declines in most industries.

Beyond the general favorable evolution of financial conditions, vulnerabilities persisted in specific groups. Larger companies' indicators showed a stronger recovery, which contrasted with the persistent lag in the recovery of smaller firms, those that received Fogape loans during the pandemic, and, in general, in the construction and real estate sectors.

The weakness of the residential real estate sector had continued, driven by a number of factors, including the level of mortgage rates, low demand, and the high stock of finished homes. Home prices had shown a slight increase and, as noted in previous IEFs, a significant downward adjustment remained a risk factor.

As for bank lending activity, it was still in a contractionary cycle, which was mainly explained by a weakening of commercial credit, associated with a still weak demand and stable supply conditions (Bank Lending Survey, Business Perceptions Report). Meanwhile, although the housing portfolio showed limited growth, its dynamics remained stable. The credit-to-GDP gap remained negative, explained by the contraction of credit and, GDP growth. Lending interest rates continued to evolve in line with their benchmark rates.

For the banking system, delinquency had improved at the margin, tending to the levels observed in the pre-pandemic period. Sufficient provisions and collateral had been set aside to cover the higher levels of non-performing loans. Profitability had recovered and was around historical averages. Banks showed high liquidity indicators while their funding conditions remained normal. The banking system had further strengthened its capital base and solvency indicators in line with the process of convergence to Basel III standards. Since the last FPM, new issues of perpetual bonds had materialized.

2. Background analysis and discussion

The most relevant development since the previous FPM was the increase in global economic uncertainty following the tariffs imposed by the U.S. administration on a large group of countries and their responses. Therefore, the main risk to local financial stability came from abroad, and, in particular, from a resurgence of geopolitical and commercial tensions.

Although financial conditions for emerging economies were considered to have been more benign compared to previous periods of stress, a sudden adjustment in global risk appetite could lead to a correction in asset prices, which would deteriorate financial conditions facing emerging economies.

It was pointed out that the shallower local financial market —as compared with previous episodes— could reduce its capacity to cushion the effects of abrupt changes in portfolios on financial variables.

It was also noted that global tensions could have a negative impact on both local economic activity and the repayment capacity of households and firms. Thus, scenarios in which these effects would have an impact on local activity, the labor market, and the repayment capacity of households and firms could not be ruled out, and these repercussions would be stronger if trade and geopolitical tensions intensified.

Overall, the Chilean economy had overcome the imbalances of previous years, which would allow households and firms to face a deterioration of the economic scenario in a better position. Debt-at-risk (DaR) had decreased among firms, mainly explained by the better initial repayment situation of the retail and wholesale sector. For individuals, DaR was largely unchanged from the previous year, although the latest information suggested that the DaR of borrowers had continued to decline.

The stress tests showed that local banks would remain solvent in the face of a severe shock. In such a scenario, in which activity sharply contracted, funding costs increased, and financial conditions deteriorated, the banking system's capital level would be able to absorb potential losses. The availability of additional capital buffers, to which the issuance of perpetual bonds and the construction of regulatory buffers had contributed, had improved its capacity to absorb shocks in times of financial stress. In these scenarios, considering the most demanding capital metric (CET1), banks also remained solvent, with some banks of varying size making partial use of the regulatory buffer provided for these purposes.

The upsurge of external risks reaffirmed the importance for local agents of having the necessary buffers at hand to face such scenarios. In this regard, although some challenges remained, progress in convergence with Basel III and the implementation of macroprudential policies, such as the CCyB, reinforced the resilience of the banking system and contributed to the economy being able to better confront the potential materialization of these risks. It was pointed out that the institutional framework governing the Chilean economy allowed for the availability of buffers and tools to mitigate the effects of adverse shocks. In addition, the institutional framework contemplated a series of tools to be used in exceptional situations --which had been complemented with new powers incorporated in the Resilience Law-- and instances of coordination between the different branches of government, regulators, and supervisors.

3. Analysis of policy options

Regarding the policy options, the Board unanimously agreed that the option to hold the countercyclical capital buffer (CCyB) at 0.5% of risk-weighted assets was the only plausible option at this Meeting. This was consistent with the macro-financial conditions and the risk scenario facing the financial system, which are analyzed in detail in the Financial Stability Report (IEF) for the first half of this year. This option was also consistent with the November 2024 communication following the publication of the new methodological framework for the CCyB implementation, which strengthens the resilience-enhancing role of this macro-prudential tool when facing a stressful scenario. It was emphasized that this risk environment underscored the importance of having a capital buffer previously built up by the banks, which would enhance their capacity to withstand shocks and which could be reduced or released in the event of a severe financial stress event, thus helping to mitigate its impact on the provision of credit to households and businesses.

The Board estimated that the main risks to financial stability facing the Chilean economy were associated with the external scenario, particularly the tensions generated by the trade war and geopolitical conflicts. It was noted that the unexpected magnitude of the announcements had caused significant movements in the prices of financial assets and an increase in volatility. At the same time, several Board members pointed out that several vulnerabilities of the external scenario, identified in previous IEFs, such as the elevated public and private debt in the world, the long-lasting high levels of long-term interest rates and the high valuation of financial assets, were still in force.

The Board considered that, within the country, credit users were in a good position to deal with a shock, although with heterogeneity and lags in some sectors. It was mentioned that, although local financial conditions had shown a benign behavior in this episode and household and corporate financial indicators showed a recovery, there was still low credit activity, which was mainly associated with demand factors.

There was agreement that the banking system had good liquidity ratios and adequate capital levels to withstand severe stress episodes, based on current regulatory requirements. It was also noted that the banks had been further strengthening their capital bases while continuing to comply with the Basel III standards adequacy process.

The Board added that what had been communicated in November 2024 when revealing the updated Framework for the implementation of the CCyB was still in effect. Thus, in view of the Basel III convergence process being still underway, it was established that, as of the first half of 2026, an assessment would be made as to whether macro-financial and credit conditions would allow convergence to begin towards the neutral level defined for the CCyB, in which case a period of at least one year would be given for compliance.

4. Financial policy decision

Governor Costa, Vice-Governor Novy, and Board members Naudon, Céspedes, and Soto voted for holding the countercyclical capital buffer (CCyB) at the level of 0.5% of risk-weighted assets.