Macroprudential Policies: A View from Chile

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Chile has not been active in the use of macroprudential tools

- We have been prudent about macroprudential policies
- Pragmatism and a healthy dose of skepticism in the face of a rising policy framework
- Especially when your financial system has been in good shape and you do not feel the compelling need to act
- Why did our financial system fared relatively well during and after the crisis? Does it has any relation to what today is understood as Macropru?

What has worked? Why has our financial system been resilient?

- An internally consistent macro framework.
- Tight regulation and supervision of banks' behavior and activities through the cycle aimed at limiting complexity and interconnections: policy decision to keep it simple.
- Adequate monitoring, evaluation, and communication of systemic risks by an independent central bank. Signaling matters.

Outline

- Banking regulation in Chile: simplicity by design
- Signaling by the central bank as a MP tool
- Why did we abandon CAM?

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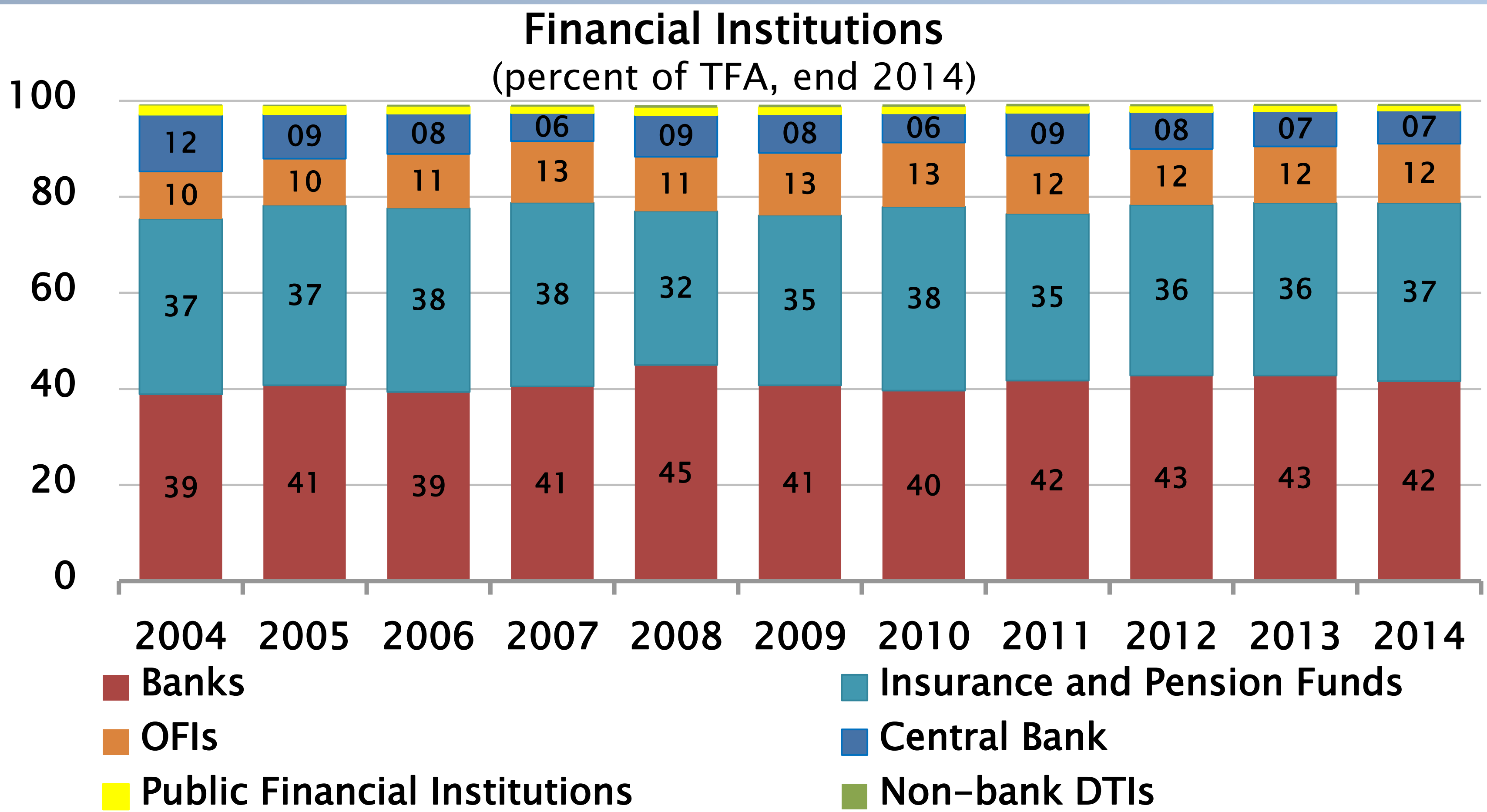
Chilean financial system is largely dominated by banks



Source: Central Bank of Chile, SVS, SBIF and SP

Chilean banking law clearly defines and limits banks activities

Allowed operations for banks in Chile (LGB)
Taking deposits, offering current accounts, making transfers and payments
Issuing senior bonds, mortgage linked bonds, guaranteed and unguaranteed loans
Issuing letters of credit, payment orders and guarantees of deposits
Issuing and trading commercial paper
Trading derivatives according to Central Bank regulations, and engaging in exchange rate operations
Offering services of securities custody
Issuing and operating credit cards
Acting as investment agent and stock underwriter
Buying, keeping and selling securities and other assets in order to provide banking services;
Establishing on-shore subsidiaries and acquiring ownership stakes in foreign firms
Subsidiaries in Chile are allowed to act as securities agents; broker dealers; Mutual or investment funds administrators; and insurance broker.
Subsidiaries are not allowed to buy shares unless it is stricly necessary for its functions (parent banks are not allowed to buy or hold shares)

Crucially: no stocks, no commodities, limited set of derivatives

…and is relatively restrictive in terms of risk weights (…and no IRB)

Risk weights in the standard Basel II model and in Chile (General Banking Law)

Bank Assets	Basilea II	LGB
Cash	0%	0%
Exposure to sovereign or central bank debt	0-100%	o 100%(2)
Trade credits (1)	0-100%	100%
Commercial mortgages	100%	100%
Multilateral development banks	0%	100%
Banks (1)	20-100%	100%
Consumer	75%	100%
Home mortgages	35% o >	60%
90-day default portfolio (net of provisions) (1)	100%	100%
90-day default portfolio (net of provisions), mortgages	50-100%	100%

(1) A weight of over 150% could be applied to: sovereign, state-owned or bank debt or corporate securities rated lower than B-; commercial credit rated lower than BB-; and mortgage loans in default with provisions of less than 20% of the debt.
(2) Sovereign or Central Bank of Chile debt: 10%; remainder: 100%.
Source: Central Bank of Chile, based on BIS and SBIF data.

As a result, the balance of banks is relatively simple

Assets of banking system

(%)

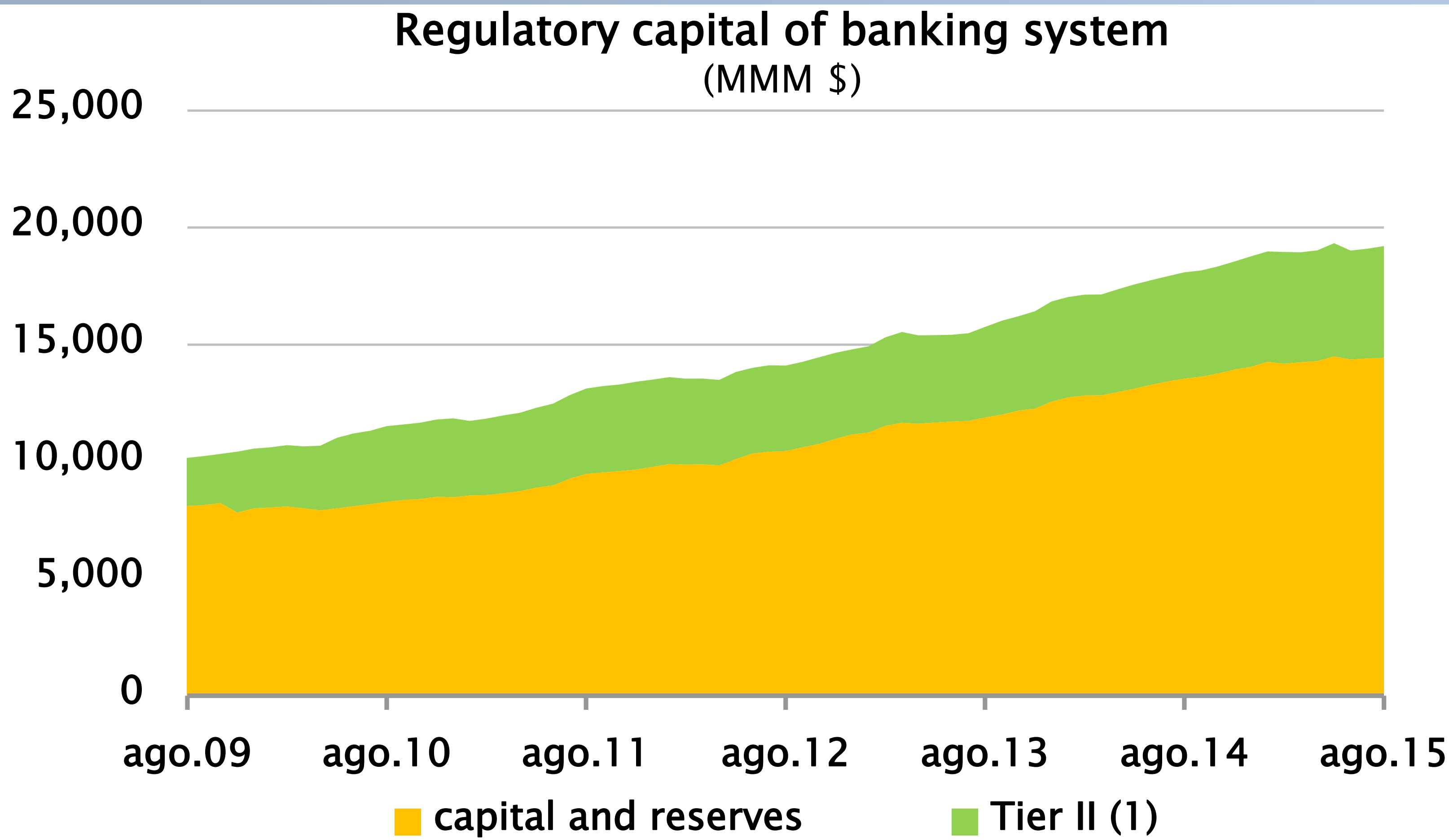
Assets	2008	sept 15
Cash	4	5
Consumer loans	8	8
Commercial loans	42	41
Home mortgages	16	19
Foreign trade	8	6
Securities	12	9
Derivatives	7	7
Other assets	3	5
Total assets	100	100

Liabilities of banking system

(%)

Liabilities	2008	july 15
Demand deposits	13	17
Time deposits	47	39
Foreign liabilities	7	4
Foreign bonds	1	5
Debt securities	13	14
Derivatives	6	7
Other liabilities	7	6
Capital and reserves	8	8
Total	100	100

...and banks' capital is good quality CET1

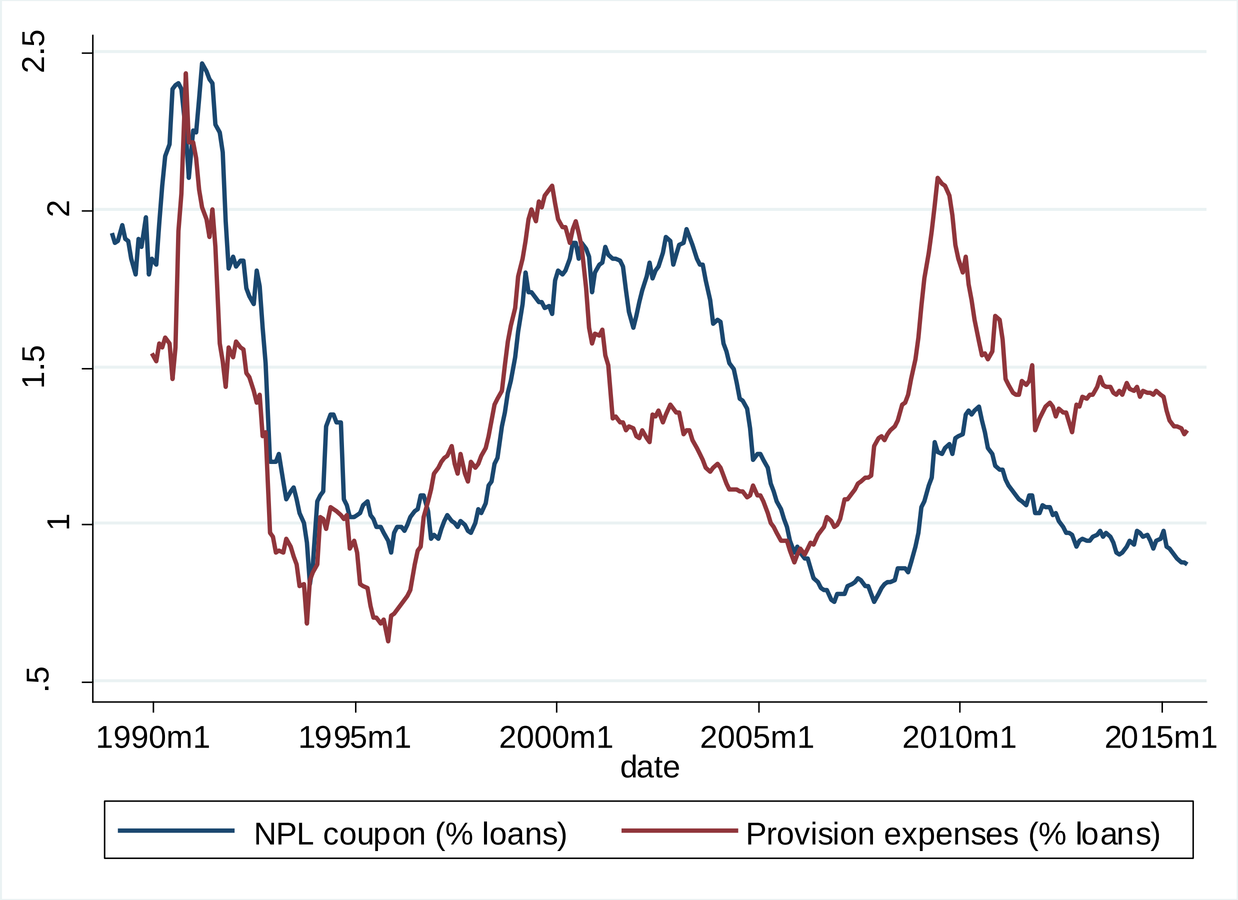


(1) Includes subordinated bonds, additional provisions, etc..
Source: Central Bank of Chile.

Our regulatory framework also includes some macroprudential features

- Limits to related lending and interconnections
- Higher capital requirements for larger banks
- Limits to maximum LTVs in securitizable mortgages
  - We will soon introduce provision rules that penalize loans in the banking book with high LTVs
- Requirement to explicitly consider exposures of borrowers to IR and FX risk and the state of the business cycle in the determination of provisions.

Indeed during the crisis provisions increased before NPLs



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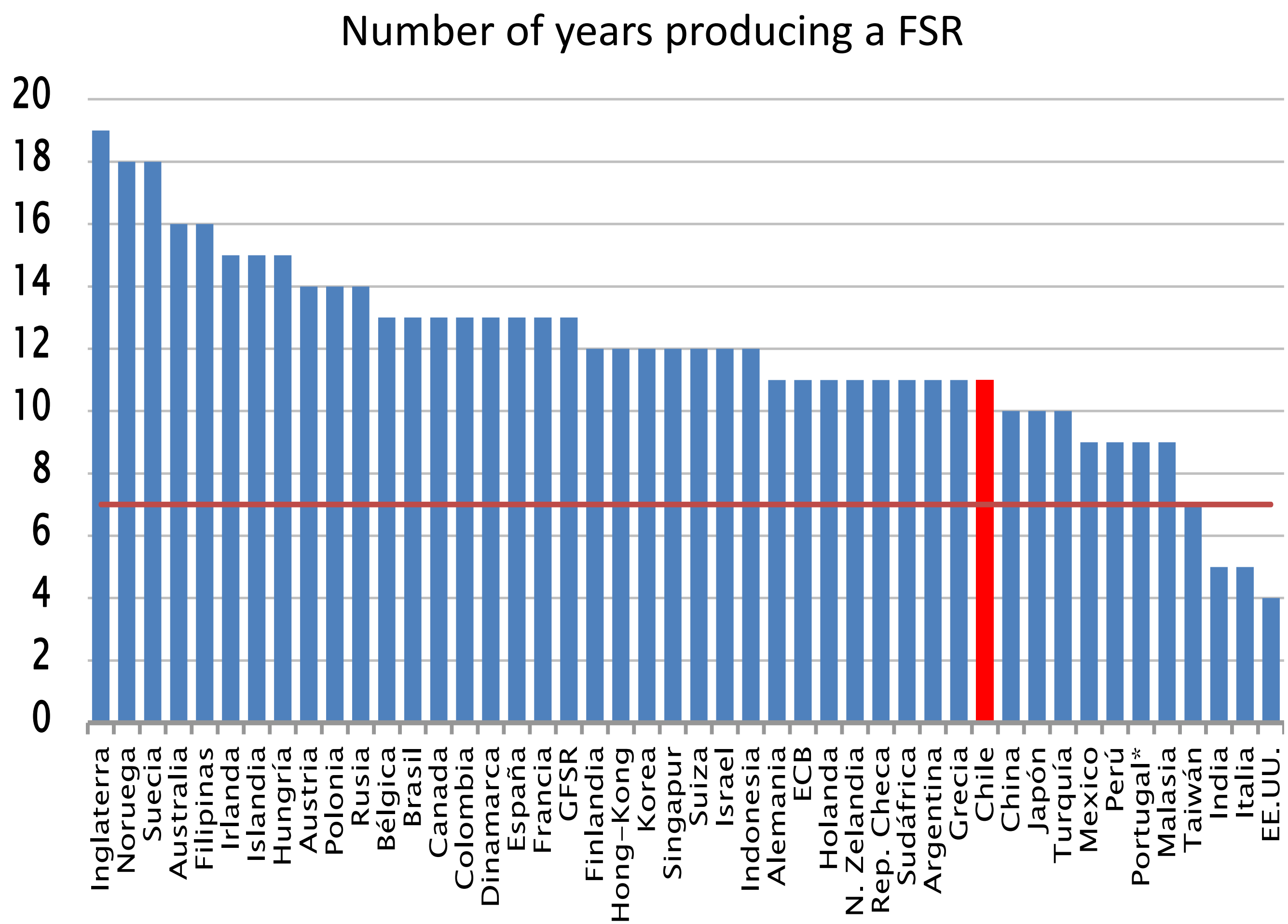
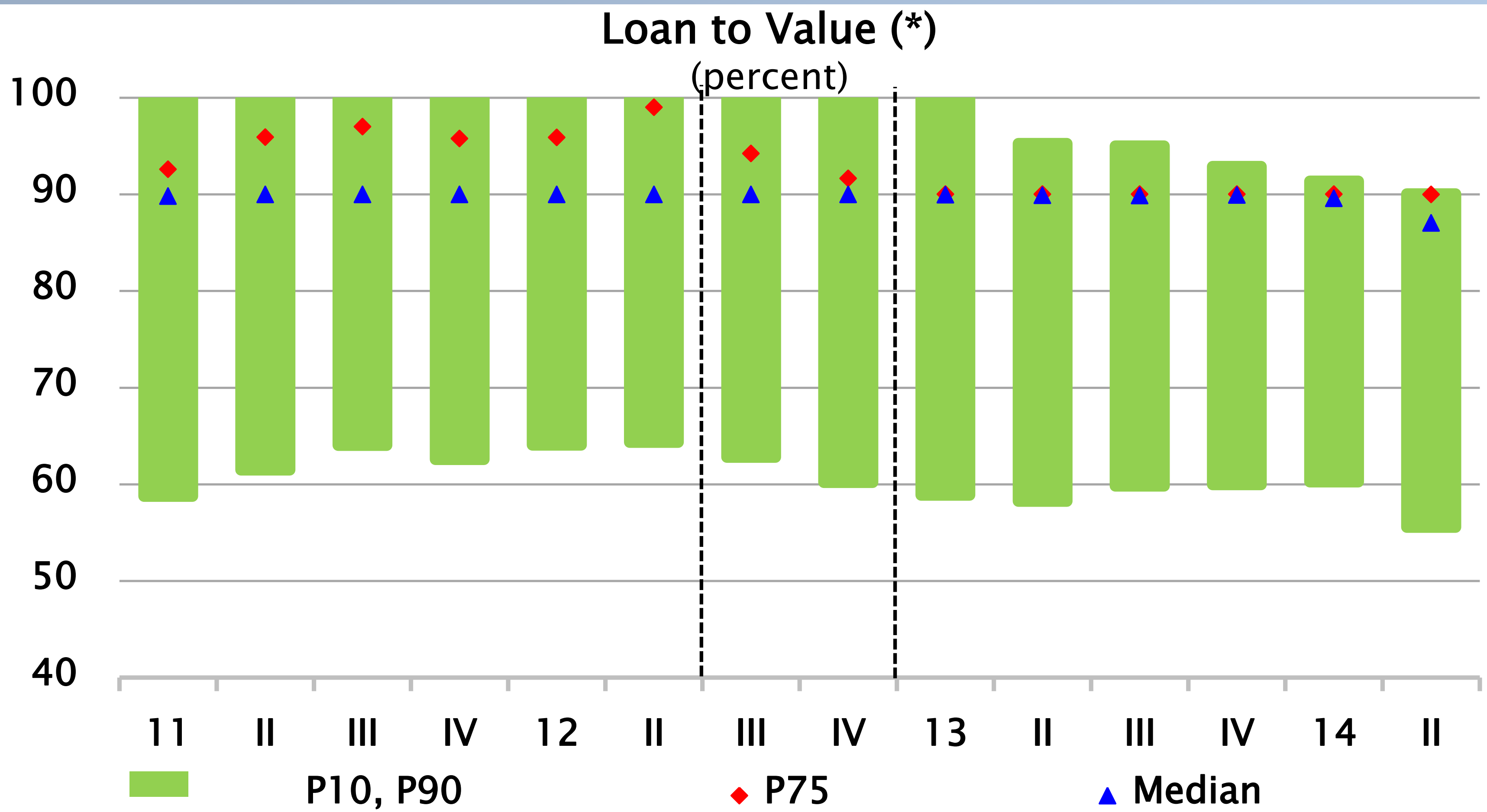
The Central Bank has maintained for several years a close monitoring of financial stability issues



State, vulnerabilities, and risks, shared with participants and supervisors

- FSR is shared with supervisors before its public release
- Results of individual-bank stress tests are discussed with bank supervisors
- FSR is widely disseminated among market participants and presented to congress twice a year.
- We have occasionally issued specific warnings about developments in some markets that have had bite even before actual measures are taken…

Lending conditions in mortgages tightened after CB warning



(*) The vertical dashed line indicates the central bank warnings about possible risks associated with the dynamics of the housing market.
Source: Central Bank of Chile, based on data of SII.

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What do we know about the effectiveness of CAM measures?

- Chile had a system of URR on certain forms of credit during 91-99.
- URR had little to no impact on the overall level of capital inflows.
- URR may have had some impact on the composition of inflows, reducing ST and increasing LT
  - Increase in non-taxed ST flows.
- It required a permanent tinkering with its conditions as loopholes were discovered
  - Changes in the base and holding period
- It had little to no impact on exchange rate or MP room
- Sand in the wheels? Maybe, but our experience suggests that wheels keep moving fast unless you throw them a rock..

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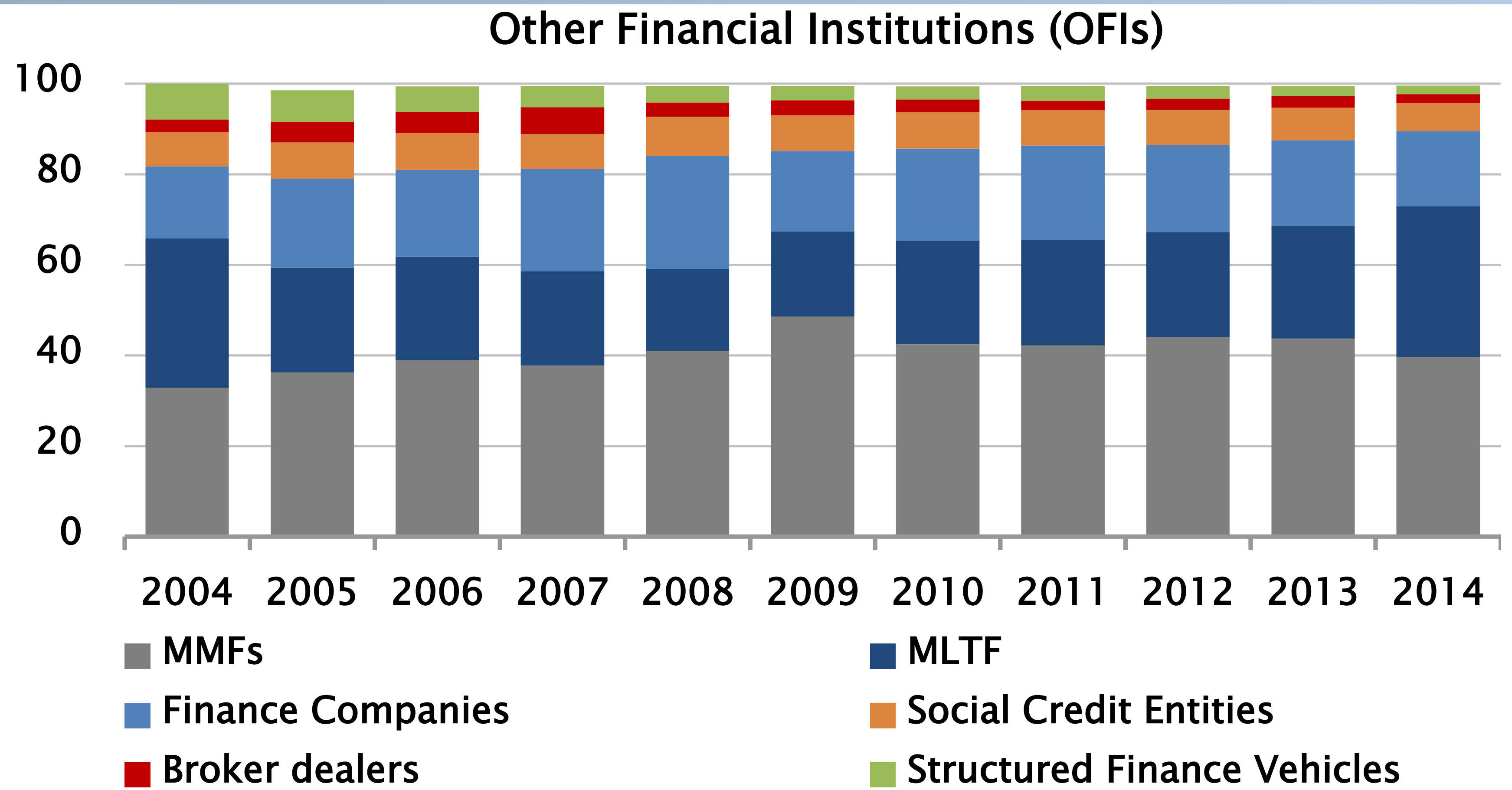
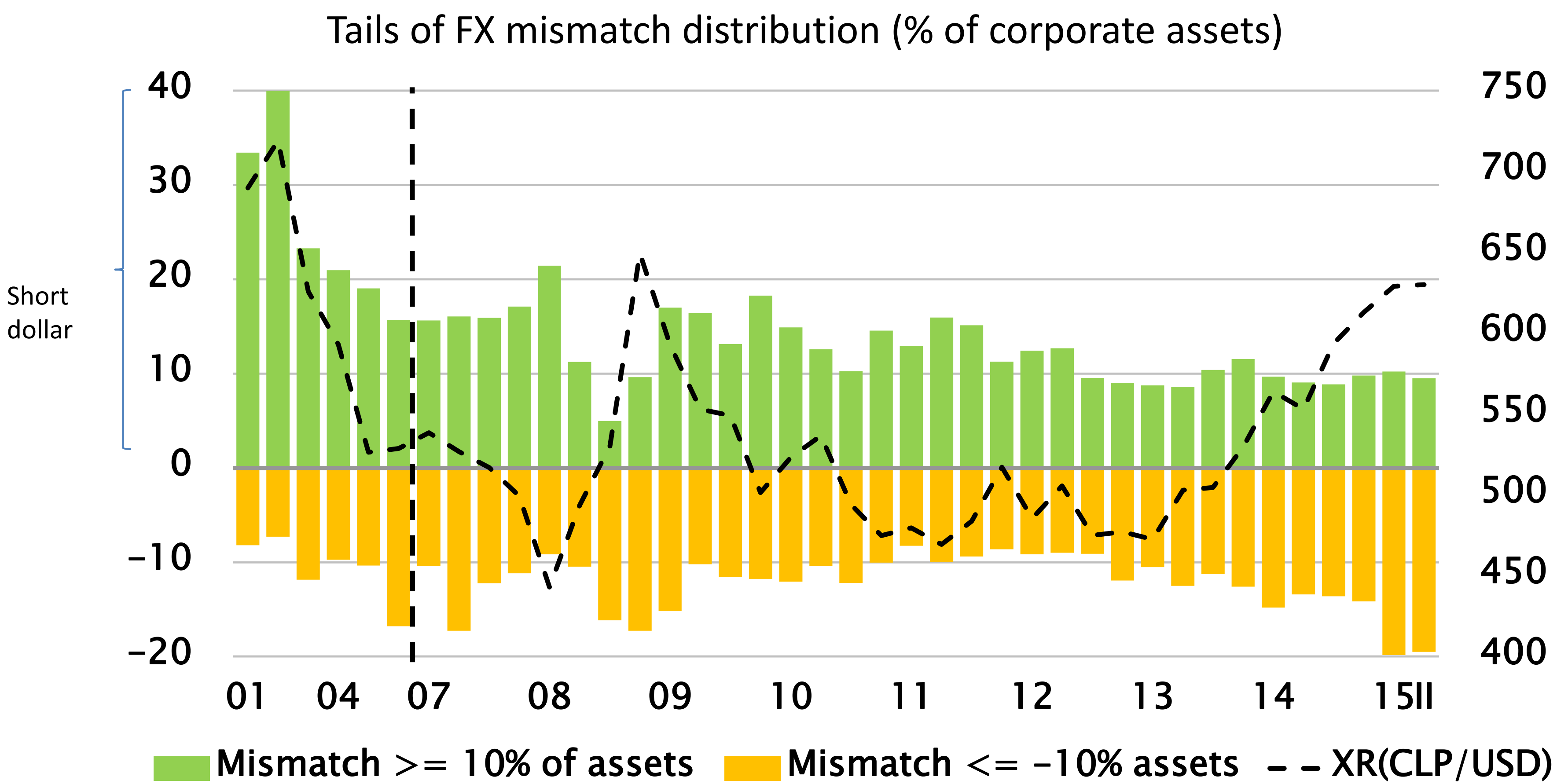
And our SB is mainly concentrated in mutual funds

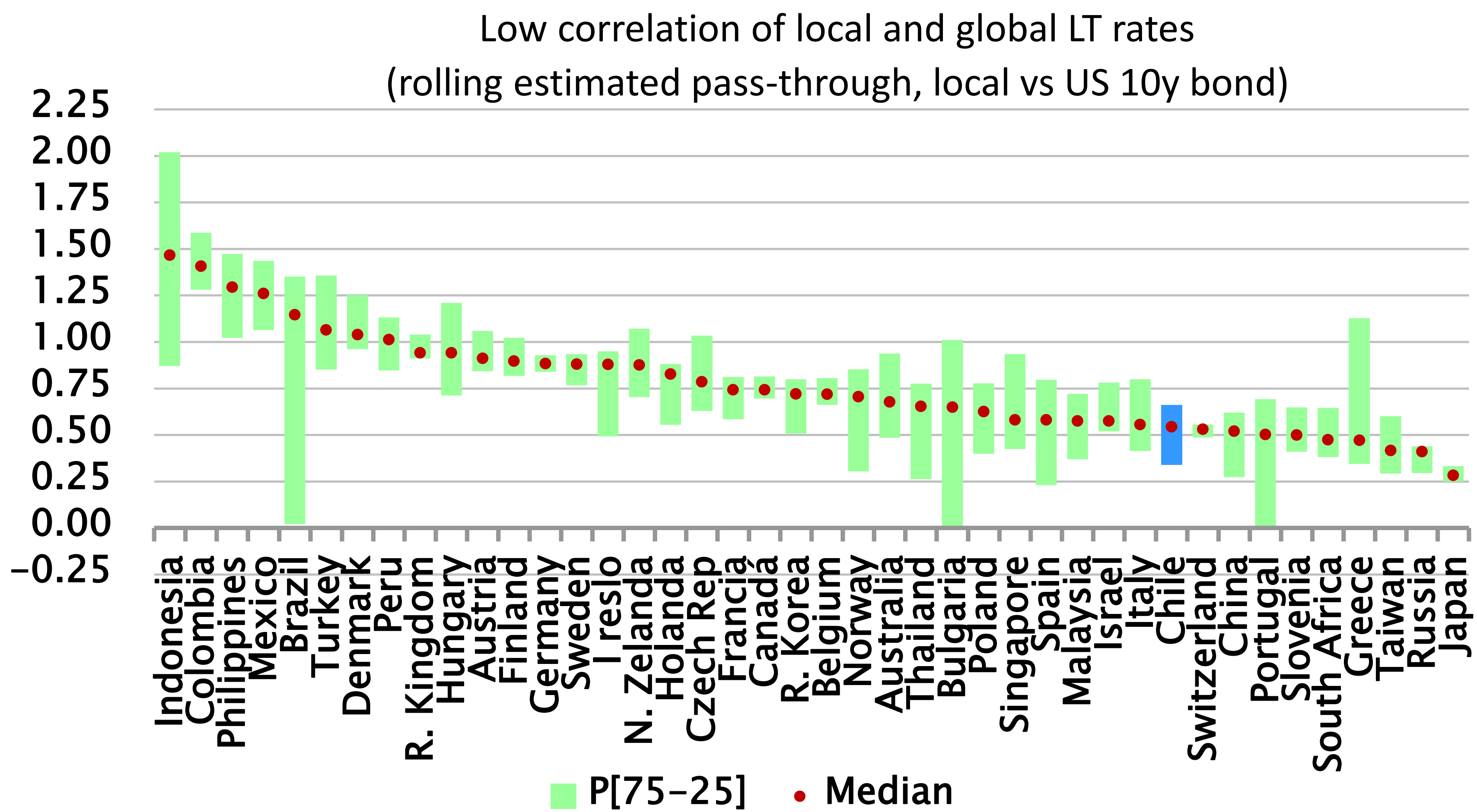


Source: Central Bank of Chile, SVS, SBIF and SuSeSo

Full FX liberalization has reduced firm's FX exposures



Development of local base of institutional investors has helped us



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Pension funds have dampened movements in capital inflows from non-residents
(US$MM, PFAs 3m moving cumulative flows)