# Financial Stability Report

# Presentation before the

# Finance Commission of the

# Honorable Senate of the Republic*

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*The *Financial Stability Report* for the second half 2024 can be found at http://www.bcentral.cl.

**Introduction**

Mr. President of the Finance Commission, senator Felipe Kast, senators members of this Commission.

As is customary in May and November, we are here to present the vision of the Board of the Central Bank of Chile on recent developments in the financial sector and their implications for financial stability, which are detailed in the Financial Stability Report (IEF) that we published this morning.

On Monday and Tuesday of this week we held our Financial Policy Meeting, at which time the Board of the Central Bank decided to hold the Countercyclical Capital Requirement (CCyB) for the banking system at a level of 0.5% of risk-weighted assets (RWAs). This requirement is a precautionary macroprudential measure aimed at strengthening the resilience of the banking system, particularly so that the provision of credit is not affected at times when the economy could suffer a major economic shock.

The IEF is part of the mandate to ensure the normal functioning of internal and external payments granted to us by law. Its objective is to analyze the vulnerabilities, potential risks and mitigators of our financial system and its capacity to absorb severe shocks. It is therefore a report that, unlike the Monetary Policy Report (IPoM), does not contain projection scenarios, but rather focuses on risk scenarios that, although less probable, are possible.

In this IEF we highlight that the external scenario continues to be the main source of risk for local financial stability. Although the cycle of monetary normalization policy has begun in the United States, uncertainty associated with global geopolitical tensions and the scope and impact of potential economic and trade policies on the American economy has increased. In addition, some sources of risk persist at the global level, such as the high valuation of financial assets, the persistence of high long-term interest rates and the high sovereign and corporate debt.

In our country, the reductions in the Monetary Policy Rate (MPR) have been passed on to short-term market rates. Long-term ones, on the other hand, remain high, affected by both external market conditions and the lower depth of the local capital market.

The process of normalization of companies' financial indicators has continued, albeit with heterogeneity among sizes and sectors. Thus, a greater lag is observed in smaller companies, in companies in the real estate, construction and trade sectors and also in those that obtained Fogape loans during the pandemic, which has increased default. The financial situation of households has also improved, although their net financial position remains below pre-pandemic levels.

Local banks have sufficient provisions, guarantees and capital to face adverse events. The banking system has strengthened its capital base in the process of implementing Basel III requirements and has capital buffers that contribute to increase its resilience to the eventual materialization of systemic risks. Among the upcoming challenges, it must continue to

manage the increase in credit risk in its portfolio and continue to prepare for the full convergence to Basel III.

## Evolution of global and local financial markets

Let me now turn to the details of the Report's content. On the external front, the decline of inflation around the world has allowed the main economies to begin the process of monetary policy normalization.

In the United States, economic activity data have reinforced the idea of a soft landing for this economy. However, uncertainty remains regarding the pace of cuts to the federal funds rate, which has been reflected in significant changes in market expectations. Recently, part of this is related to the scope and impact of potential economic and trade policies and their effects on future inflation, which has also strengthened the dollar (Figure 1).

Regarding long-term financial conditions, concerns about massive public and private debt at global level are still present with an increase that has been led by the United States and China. In the coming years, several factors, both short and medium term, will continue to put upward pressure on public spending. For example, geopolitical tensions could trigger an escalation of defense spending, in addition to the need to finance structural expenses, such as the investment needed to address the climate transition.

Turning our eyes to our own economy, we see that the evolution of short- and long-term interest rates is similar to that described in the external scenario. The MPR cuts have been passed on to the cost of commercial and consumer loans. Compared with the peaks of this cycle, the average rates on these loans have fallen by around 700 and 600 basis points (bp), respectively. On the long term side, sovereign bond rates have fallen since the close of our previous IEF (late April), although they remain high in a historical comparison. The same is true for corporate bond rates and spreads. The main purpose of local bond issues has been to renew and bring advance upcoming maturities, in a market that still shows low dynamism compared to the pre-pandemic period. Local risk indicators (i.e., sovereign risk, stress, uncertainty and asset price volatility) remained without significant changes.

In this context, compared to their levels at the end of April, two-year market interest rates fell by around 60 bp on average for developed economies and around 40 bp for emerging ones. In Chile, this decrease was close to 70 bp. Meanwhile, in several economies, long-term interest rates have risen in recent weeks, approaching the levels that prevailed at the end of April. In Chile, these increases have been somewhat smaller (Figure 2)

## The financial situation of credit borrowers

Aggregate corporate debt remained stable in the second quarter of this year, although with changes in its composition. In particular, weaker dynamism of local bank credit was offset by higher external debt in bigger companies. The latter was associated with foreign direct

investment (FDI), new bond issues abroad and an increase in the valuation of their debts in foreign currency due to the depreciation of the peso (Figure 3).

The evolution of the financial indicators of companies is heterogeneous, in a scenario in which the lower rates on commercial loans have eased the financial burden and short-term refinancing conditions. In bigger companies, their operating margin, indebtedness and financial burden have improved compared to the previous IEF (Figure 4).

In the case of smaller companies, however, the lag in financial indicators persists. The same occurs in firms in the real estate, construction and trade sectors and also in those that obtained Fogape loans during the pandemic. Companies belonging to these groups continue to concentrate the increase in default, while banks have tended to reduce their exposure to them (Figure 5).

The residential real estate sector continues to lag behind the rest of the economy. It is noteworthy that long-term financing rates and mortgage rates remain high, beyond some decline in recent weeks; sales remain low; the stock of finished homes remains high; and housing prices have been stable in recent quarters (Figure 6). In the non-residential sector, the office situation shows no major changes, with high vacancy and historically low prices (Figure 7).

Households' financial situation is improving, with a falling financial burden, especially in the lower-income segments, whose debt is concentrated on consumer loans. Households' real income has continued to increase, as has savings, although their net financial position is yet to restore its pre-pandemic levels (Figure 8). Defaults in the consumer segment have fallen but have increased for mortgages. However, the latter remain below their historical levels (Figure 9).

About the government, official projections indicate that during the period 2025-2029 the public debt will remain below the level that the authority has defined as prudent. The Autonomous Fiscal Council has warned that there are risks to this consolidation, to the extent that it requires rigorous behavior regarding revenues and expenditure. It is important to note that maintaining sustainable sovereign debt boosts the economy's capacity to mitigate the impact of future shocks and improves the perception of risks to the local economy, allowing local agents to have better access to external and internal financing at a lower cost (Figure 10).

Our banking system has strengthened its solvency position as a result of the convergence process to Basel III, and has capital buffers, including the countercyclical capital buffer (CCyB), which contribute to strengthening resilience to sustain the provision of credit in the event of systemic risks materializing.

Banking profitability remains somewhat above its historical average, with a higher incidence of interest margins, which have recovered. Moreover, banks continue to have adequate levels of liquidity and stable long-term funding. Among the upcoming challenges, it will have to continue managing the increase in the portfolio's credit risk and its preparation for full

convergence to Basel III, which will take place at the end of 2025. It is worth noting that default indicators continued to rise, which finds the banking sector with adequate levels of provisions and capital (Figure 11)

**Main risks**

As I noted at the beginning, risks from the external scenario continue to be the main concern for local financial stability. On the one hand, some risks identified in previous reports remain in place. Among them is the pressure on long-term interest rates exerted by the high levels of public and private debt in the world, together with high fiscal deficits. Added to this is a high valuation of financial assets, which represents a vulnerability to abrupt changes in global risk appetite (Figure 12). Likewise, non-bank financial institutions continue to be a source of special attention globally, given their rapid growth in financial intermediation, while gaps in information on their interconnections with the rest of the financial system remain.

Locally, financial market depth remains low from a historical perspective, which increases exposure to global developments, especially in the face of abrupt reversals in financial prices (Figure 13).

In addition to the aforementioned set of risks, there are others that have increased in intensity in recent months. The most notable are the increased geopolitical tensions, both due to the evolution of armed conflicts and the emergence of measures that threaten the process of globalization. This set of events could have negative effects on financial stability. For example, because in the face of greater prospects for public spending on defense, an increase in uncertainty or risk aversion could deteriorate financial conditions. This would be especially complex for emerging economies, where capital outflows could be triggered.

In addition, impacts could be observed through the real channel. This could occur if protectionist trade policies are implemented that increase trade restrictions or disruptions in the supply chain and the commodities market. Scenarios like these would put pressure on inflation and interest rates at a global level, also with potential consequences for financial stability.

**Stress tests**

Regarding the impact that a severe stress scenario would have on the financial situation of households and businesses, the results of the tests are similar to those of the previous report. In the risk balance of companies, lower debt is combined with greater initial delinquency. In the stressed scenario, the main impact comes from the shock of higher long-term rates, eroding future repayment capacity.

In the real estate sector, the weak activity that has been going on for several quarters could continue to weaken the repayment capacity of these firms. Although a significant downward

adjustment in asset values constitutes a risk factor, prudential regulation would help mitigate its effects on the financial system (Figure 14).

For individuals, the balance of risks is slightly better than a few months ago, as short-term interest rates have been falling and consumer defaults have declined, offsetting the increase in mortgage arrears. The result of the stress test is similar to that in the previous IEF, with the path of interest rates and indexation being the main determinants of future credit risk (Figure 15).

In the banking system, as the Basel III implementation process has progressed, it has strengthened its capital bases. The tests show that the system still has adequate levels of liquidity, provisions and capital to remain solvent in the face of severe stress scenarios. All this, considering the capital requirements as of December 2024. Meanwhile, the stress test taking into account a more rigorous capital metric, that is, with only the highest quality Common Equity Tier 1 (CET1), also shows that the banking system remains solvent, with some banks that would make partial use of the regulatory capital buffer contemplated for these purposes (Figure 16).

**Countercyclical Capital Buffer (CCyB)**

At our second financial policy meeting this month, the Central Bank's Board decided to maintain the Countercyclical Capital Requirement (CCyB) at 0.5% of RWAs. As noted in the statement following the meeting, we estimate that this level is consistent with the macro-financial and risk conditions facing the financial system, which I have just detailed.

We must keep in mind that this macroprudential capital charge was introduced into the General Banking Law of 2019 within the framework of the Basel III regulations. In this law, the Central Bank of Chile (BCCh) was given the power to determine this additional capital requirement for the banking system, within a range from 0 to 2.5% of RWAs. The decision must have a prior favorable report from the Financial Market Commission.

The CCyB is applied uniformly to all banks in the system. Its objective is that, in the event of a shock affecting the banking system, its deactivation will contribute to mitigating the contractionary impact on credit that amplifies the shock of the crisis on the real sector of the economy.

In May 2023, it was activated for the first time, at a level of 0.5% of RWAs. This was done in a context of greater external uncertainty, which amplified the risk of a severe external shock. At that time, considering the macro-financial conditions and the situation of the banking sector, it was estimated that the requirement could be met within one year, without causing a significant impact on credit.

Various analyses that we have shared since then confirm this initial assessment. For example, in the IEF for the first half of 2024, we presented a study that used microdata (Box III.1), which indicates that the application of various policies that had been conducted recently —

including the activation of the CCyB— did not seem to have had a statistically significant effect on the supply of banks' commercial credit at the aggregate level. Its extension over time maintains the same results. In our September IPoM, one of its boxes (Box I.2) showed that the comparative evolution of aggregate credit for a broad set of countries was consistent with what would be expected from the performance of economic activity.

In compliance with the provisions of the IEF for the second half of 2023, the Bank conducted a review of the CCyB policy framework this year. The purpose of this process was to maintain a framework in line with updated international practices, adapted to the reality of the Chilean economy, its financial system, and the progress of Basel III implementation.

As part of this process, during the year the Bank held workshops on macroprudential policy and financial stability, with the participation of leading experts in the field. Thus, together with this Report, we are releasing an update of the policy framework for the CCyB, refining its implementation strategy and reinforcing its precautionary approach and resilience criteria.

Global experience has been showing that the release or reduction of the CCyB, in the face of severe stress scenarios or the materialization of systemic risks, helps mitigate procyclical behavior in the face of a macro-financial shock and its amplifying effect on the economy. For example, during the pandemic, countries that had accumulated countercyclical capital buffers and were able to release them quickly exhibited a more stable flow of credit.

In this context, a growing number of economies have set a positive neutral level of the CCyB, which allows for the accumulation of a safety margin that can be released in episodes of severe financial stress.

According to this analysis, the Board has defined a positive neutral level of 1% of RWAs. This is the level at which it will prevail most of the time, as long as risk conditions for the financial system are at a standard level and no significant changes are anticipated. It is important to note that this neutral level has been calibrated through a number of methods used in other economies, in addition to a methodology based on a structural model. These coincide conceptually in being quantifications of the expected capital loss of banks in episodes of financial stress, which are difficult to anticipate and of significant magnitude, and which have the potential to impair the ability to continue providing credit.

Under the implementation framework that we are announcing today, during periods of financial stress or materialization of systemic risks, the Board will evaluate the buffer's total or partial release for the entire banking system. It is expressly stated that in these cases, deactivation must remain for a sufficient time —which will be announced at the time of deactivation— and that the reconstruction towards the neutral CCyB (NCCyB) will take place gradually. This will occur to the extent that the recovery of the financial system is consolidated, and it is estimated that the banking system has the capacity to increase its capital with limited effects on the provision of credit.

It is also important to note that the calibration of the NCCyB at 1% of RWAs considers the policy response necessary to address a broad set of macro-financial stress situations, so possible increases in this requirement above this value should be rare.

Regarding the transition from its current level (0.5% of RWAs) to its neutral level (1.0% of RWAs), this process will occur gradually once the convergence to Basel III standards is completed in December 2025. At our first financial policy meeting in 2026 we will assess the start of convergence towards the NCCyB, a definition that will be adopted to the extent that macro-financial conditions allow and considering a period of at least one year for its gradual construction.

I will now move on the final part of my presentation.

## Concluding thoughts

Dear senators, our economy has continued to move forward in its normalization process after the important imbalances that accumulated in previous years. Some of their effects have already disappeared, such as excessive spending, the high current account deficit and high inflation. Others are still in progress, such as the level of interest rates, risk, household savings and others still show significant consequences, particularly the depth of the capital market and the level of global public debt.

Small, open economies such as Chile must always be well prepared to deal with complex episodes, particularly in an external environment where uncertainties have increased on various fronts. Geopolitical tensions have become more persistent; economic uncertainty associated with the evolution of public debt has increased; trends towards deglobalization or even protectionism are taking place. Being prepared includes having not only our capacity for analysis and anticipation, but also having an adequate set of mitigators of their effects.

Over the decades, our economy has been able to build and manage such mitigators. We have developed an economic policy framework that gives us sufficient flexibility to react to shocks, such as a medium-term inflation target, a flexible exchange rate policy, an a-cyclical fiscal policy rule, and adequate financial regulation and supervision, along with a set of financial policy tools to deal with critical circumstances.

It is important to note that, along with the central role played by financial regulation and supervision, the task of having an adequate set of mitigators involves recovering the size of our capital market that was lost after the string of withdrawals of pension savings. The capital market plays a critical role. It channels resources between the different agents. It affects the medium- and long-term financing conditions that households and businesses have access to, and the ability to mitigate external shocks that the economy may face. Therefore, it is a key element in sustaining economic development. Its downsizing is a scar that will take years to heal, a task that is of great magnitude and involves various public and private sector actors.

In this context, two important dimensions for the proper functioning of the capital market are the easy access to sources of liquidity by financial institutions and the proper functioning of the foreign exchange (forex) market, which allows agents to manage currency risks. Both attributes are particularly relevant for an emerging economy such as ours, with significant degrees of financial integration with the rest of the world.

Thus, based on our legal and regulatory powers, we are implementing a set of measures aimed at both liquidity management between private agents and exchange rate risk management. This is in addition to the progress made in strengthening the banking system, which I have already covered.

First, based on the powers conferred on the BCCh by the Resilience Act of 2023, we are working on developing capacities to conduct financial operations with non-banking entities. This will allow us to improve the liquidity management of financial entities, both in normal times and in times of financial stress. At the same time, we are building a regulatory framework to provide greater certainty to short-term collateralized Repo markets. We are doing this in a similar way to what we have done in the derivatives market, and through the recognition of framework contracts for local and cross-border operations.

The internal work to implement this new legal framework has benefited from the technical assistance of the International Monetary Fund, in which other authorities and the private sector participated, and whose results will be published in the coming months. In addition, this year we gave banks the possibility of issuing securitized bonds that can be withheld on their balance sheets.

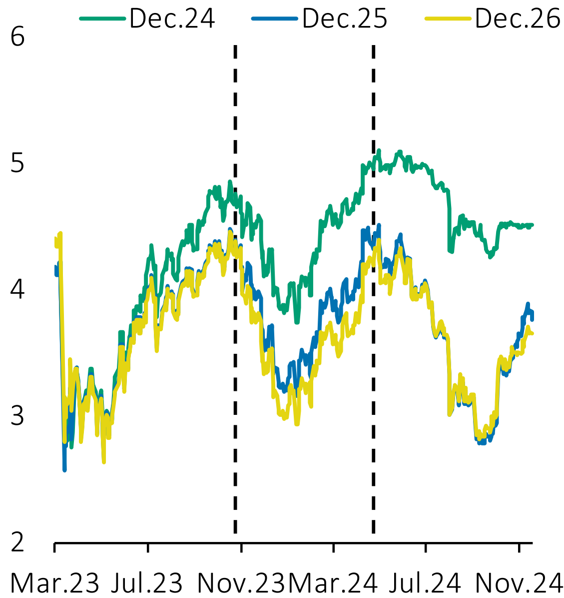
Another important part of the capital market is the forex market, which allows agents to manage currency risk. An important milestone this year is the entry into operation of a private High Value Clearing House in foreign currency. This is regulated by the Central Bank, based on the highest international standards. At the same time, we expect that the provisions of the Resilience Law will allow us to resolve long-standing problems that have prevented the development of correspondent banking in the country, which is a necessary condition for advancing in the internationalization of the Chilean peso.

Dear senators, the global macro-financial situation highlights the importance of having a resilient and deep financial system that can cope with adverse events. Geopolitical and trade tensions and the fiscal situation of developed countries suggest that long-term interest rates could remain high for a long time. In our country, markets remain shallow, which has reduced the economy’s ability to absorb external shocks. It is important that we promote initiatives that strengthen the development of the financial market. Ensuring that our economy can withstand severe shocks at the lowest possible cost is of great importance to our citizens. The Central Bank, in its role of ensuring financial stability, is firmly committed to achieving this goal.

Thank you

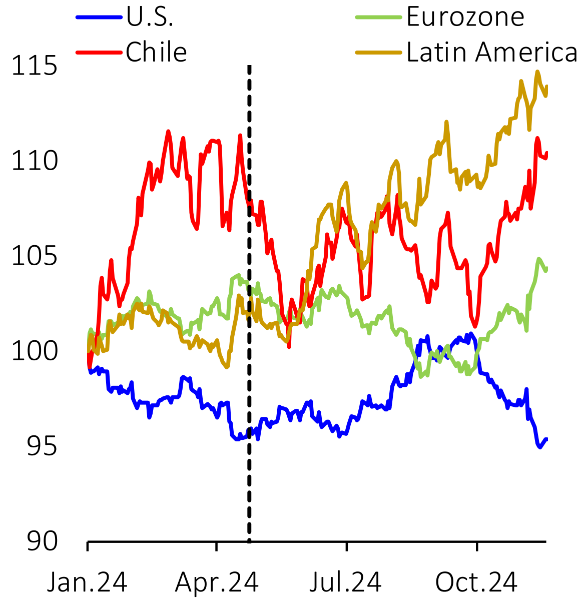
Figure 1

**Fed funds rate expected at the end of each year (1)**
(percent)




**Currencies (2)(3)(4)**

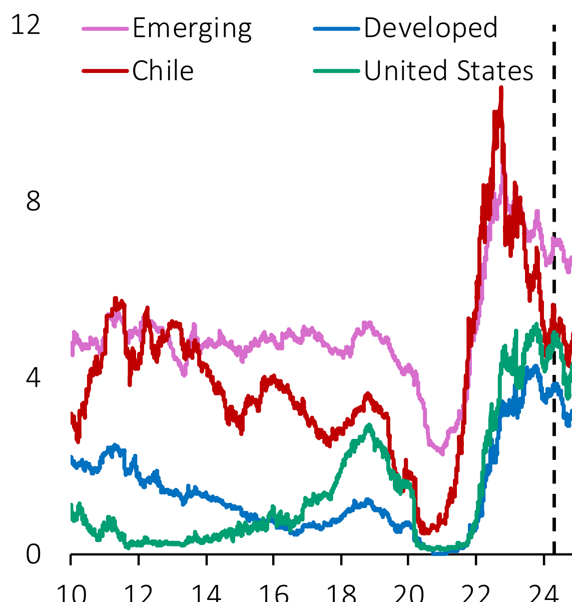
(index, 1.Jan.24=100)



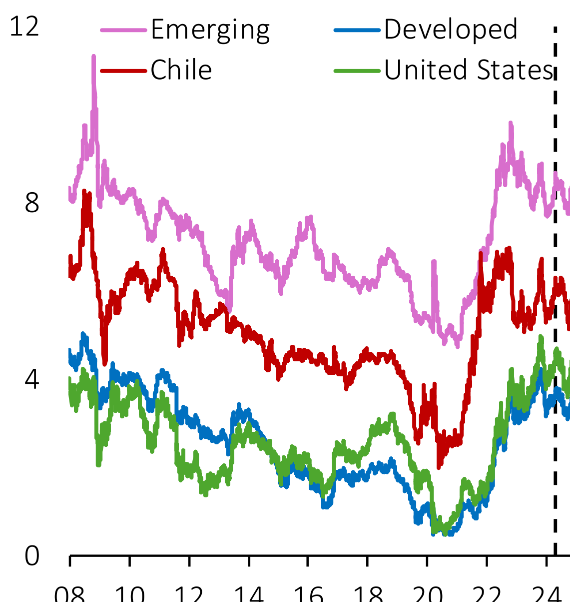

(1) Vertical lines mark statistical close of the IEF, second half 2023 and first half 2024, respectively. (2) Vertical line marks statistical close of the IEF, first half 2024. (3) For Latin America, the simple average of indexes of Brazil, Mexico, Colombia and Peru is used. (4) A higher index shows a currency depreciation and vice versa. U.S. figures are based on the multilateral exchange rate. Sources: Central

Figure 2

**Two-year sovereign rates (1)(2)(3)**
(percent)




**Ten-year sovereign rates (1)(2)(4)**
(percent)

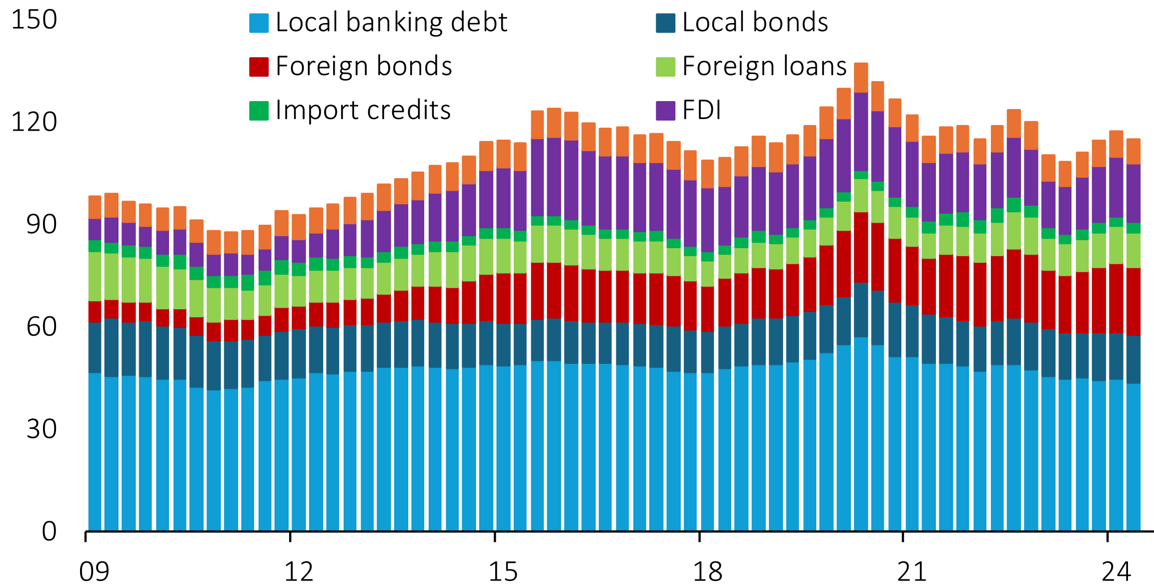



(1) Vertical lines mark statistical close of the IEF, first half 2024. (2) Developed economies in the sample are: Australia, Canada, Germany, Italy, Korea, New Zealand, Norway, Singapore, Spain, Sweden, United Kingdom and United States. (3) Emerging economies are Chile, Colombia, India, Indonesia, Mexico, Peru and Poland. For Latin America. (4) Emerging countries in this sample are: Brazil, Chile, Colombia, Hungary, India, Indonesia, Mexico, Peru, Poland and South Africa. Source: Central Bank of Chile based on Bloomberg data.

Figure 3

**Debt of non-banking firms (*)**

(percent of GDP)



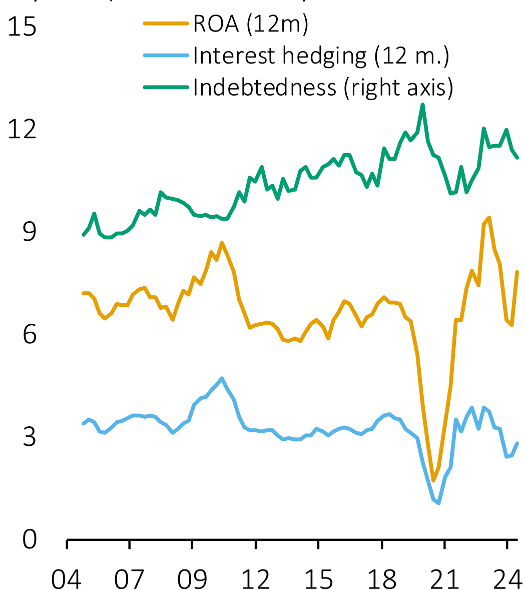

(*) Based on firm-level information except for non-bank factoring, leasing and other securitized bonds, and marketable papers. Does not include commercial college loans. Quarterly figures.

Source: Central Bank of Chile based on Achef and CMF data.

Figure 4

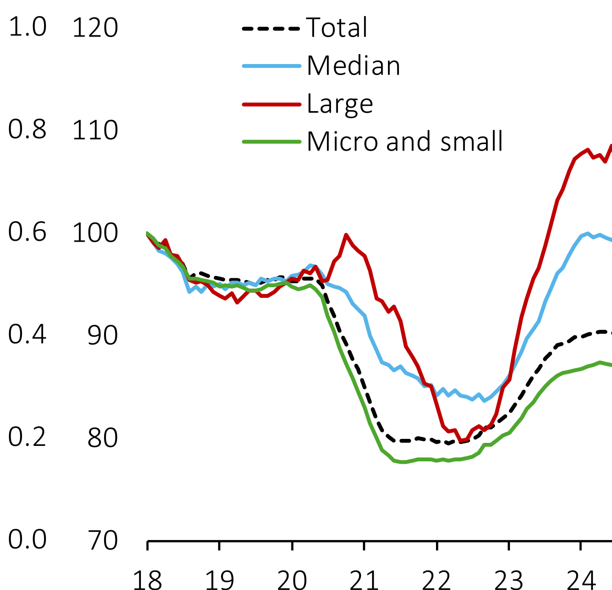
**Banking indicators (1)(2)(3)**

(percent of total assets, times financial expenses, times net worth)




**Annual operating margin**

(index, Jan.18=100)




(1) Asset profits are cumulative net income in twelve months before financial expenses and tax on total assets. (2) Interest hedging is net income in twelve months before taxes and financial expenses over annualized financial expenses. (3) Indebtedness is debt-to-equity ratio.

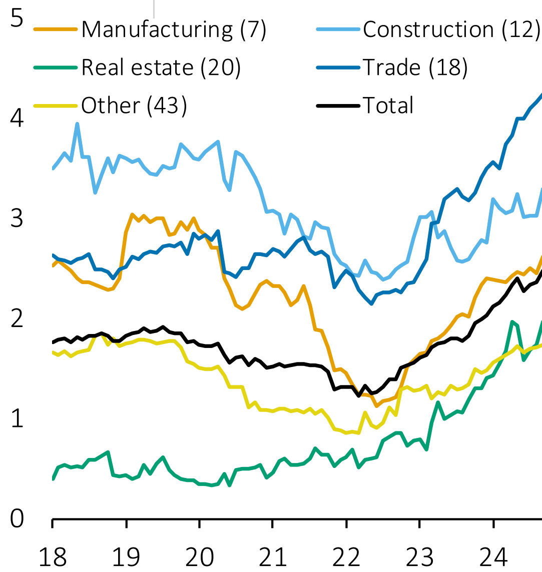
Source: Central Bank of Chile based on CMF data.

Figure 5

**Unpaid installment index (*)**

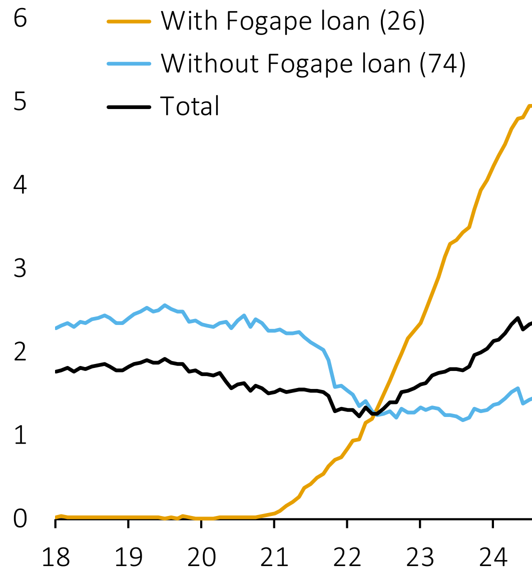
**By economic sector**

(percent of loans by sector)




**By participation in policies**

(percent of loans by group)



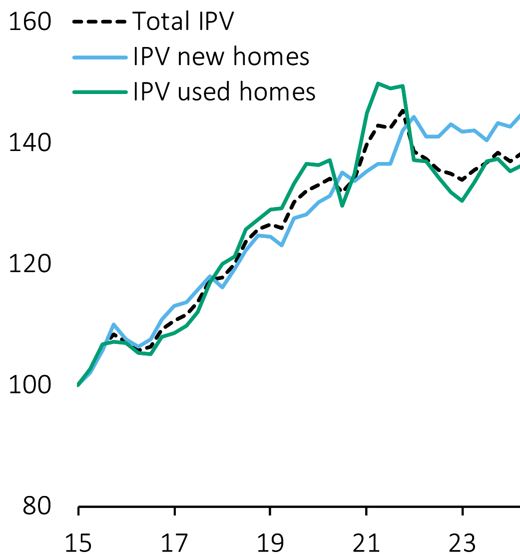

(*) Firms financed with local bank loans. Does not consider persons. Other is made up of other economic sectors, such as: Agriculture, mining, financial services, Transport & communications, natural resources and unclassified. In parenthesis, the percentage share in total loans at September 2024. The categories are mutually exclusive. Fogape corresponds to Covid and Reactiva.

Source: Central Bank of Chile based on CMF data.

Figure 6

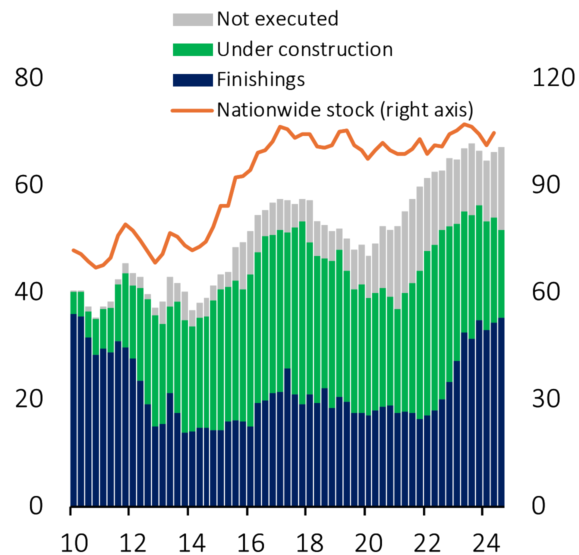
**Housing price index (IPV)**

(index, 2015.Q1=100)




**Stock of unsold new homes (*)**

(thousands of units)



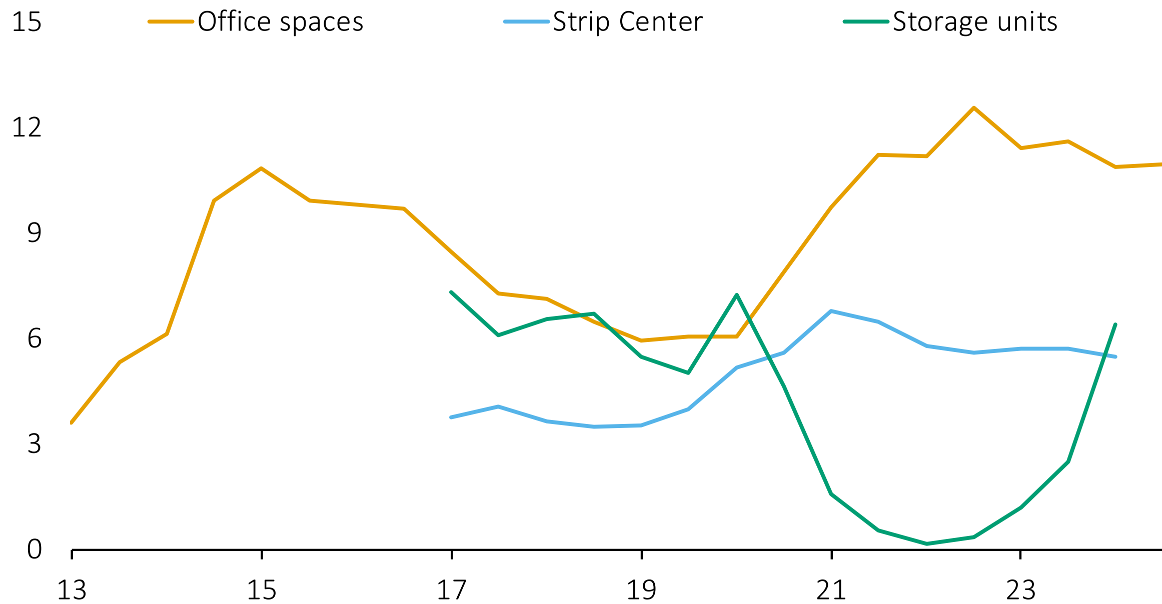

(*) “Not executed” “Finishings” and “Under construction” bars represent the stock in the Metropolitan Region.

Source:
Central

Figure 7

**Vacancies in non-residential rental market (*)**

(percent)



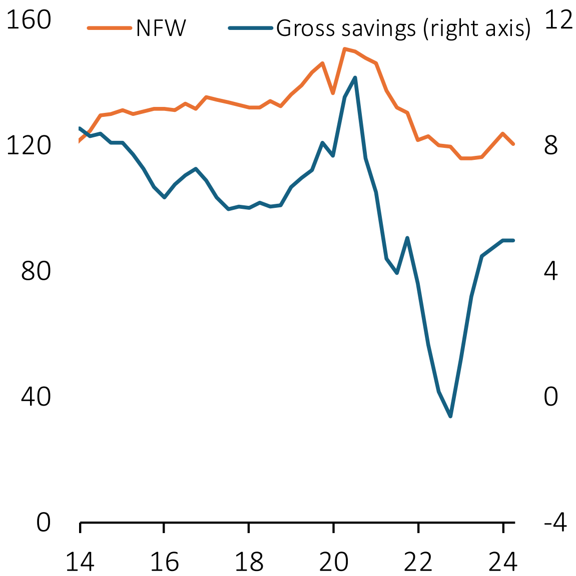

(*) Six-monthly data. Preliminary information on Office space up to 2024.Q3.

Source: Central Bank of Chile based on information from CBRE, Colliers, GPS.

Figure 8

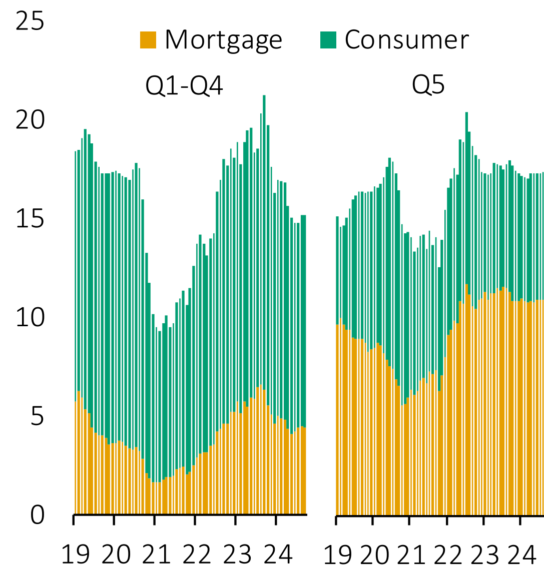
**Households' gross savings and net financial**

(percent of GDP; annual change)




**Financial burden to income ratio (*)**

(percent of monthly income; median)

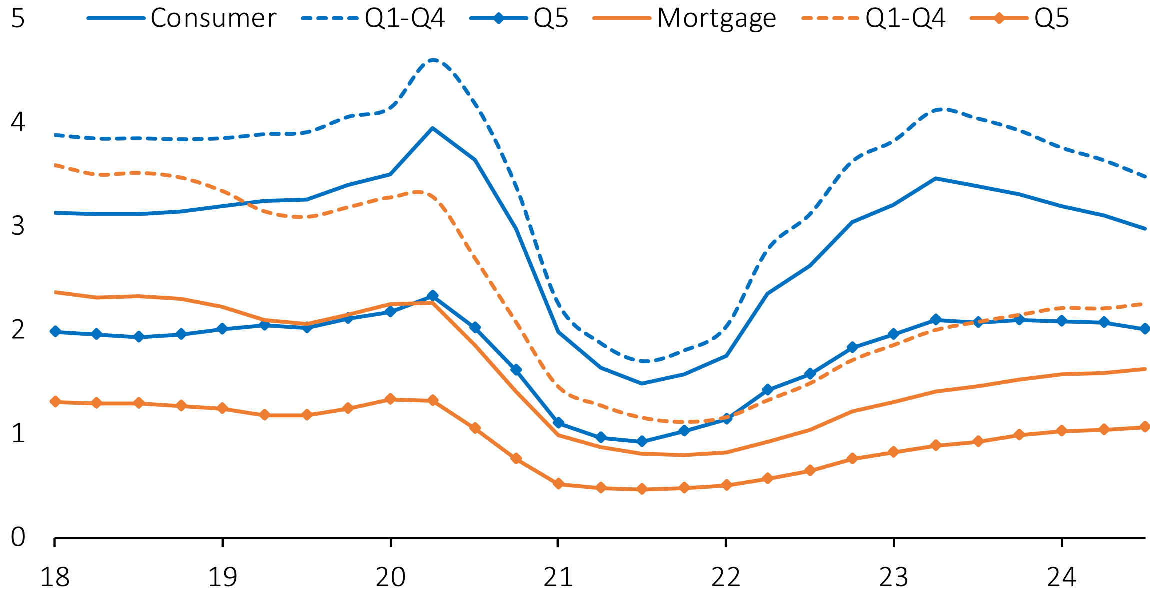



(*) Q: quintile. Q1-Q4 up to C$1,365,000; Q5 up to C$2,800,000. Q5 truncated due to taxable cap.
Source: Central Bank of Chile based on CMF and SUSESO data.

Figure 9

**Non-payment of mortgage and consumer loans (*)**

(percent of borrowers in each group)

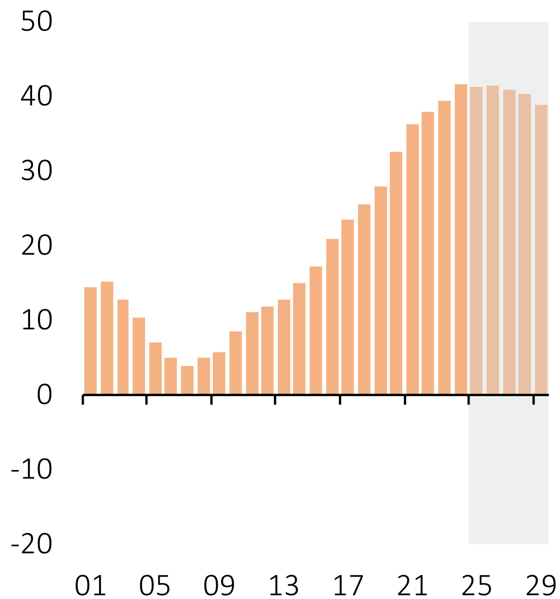



(*) Q: quintile. Q1-Q4 up to C$1,365,000; Q5 up to C$2,800,000. Q5 truncated due to taxable cap.
Source: Central Bank of Chile based on CMF and SUSESO data.

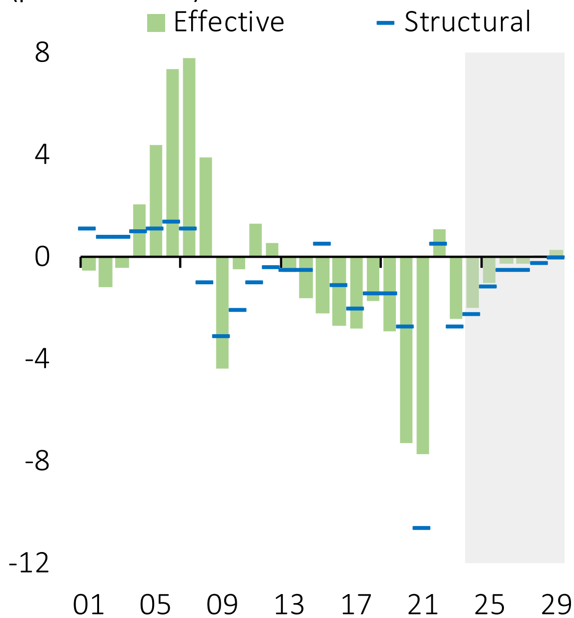
Figure 10

**Central government (1)**

**Gross debt (2)**
(percent of GDP)




**Actual and structural balance**
(percent of GDP)



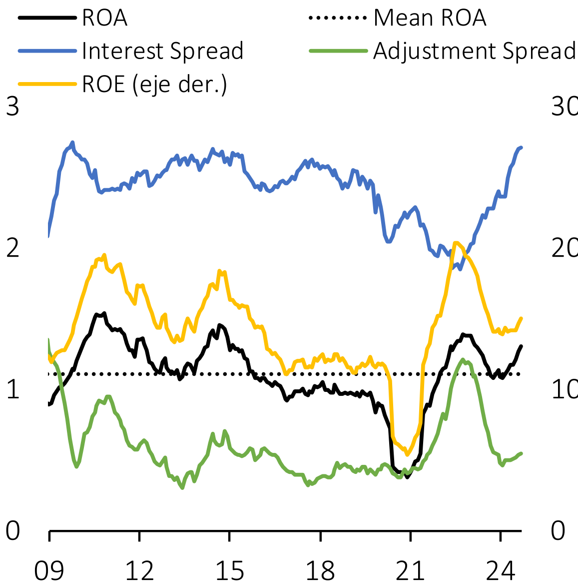

(1) Gray area shows forecast in DIPRES third-quarter 2024 Public Finances Report. (2) Gross debt 2024 as reported in the DIPRES Central Government Report at June 2024. DIPRES: Budget Office, Chile's Ministry of Finance.

Source: Central Bank of Chile based on DIPRES data.

Figure 11

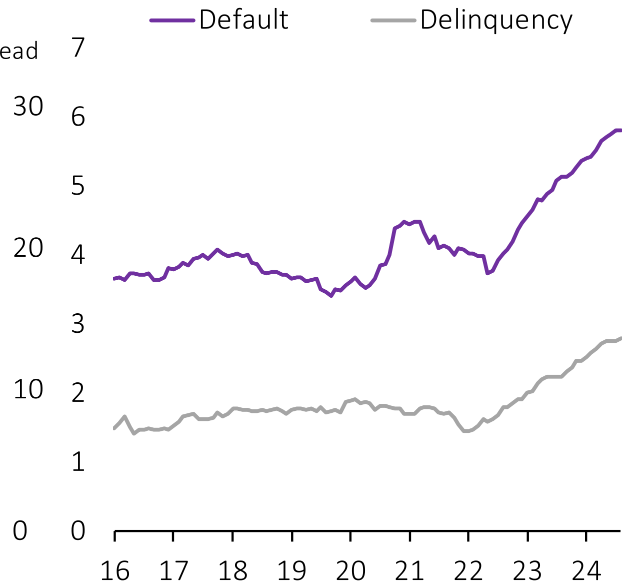
**Main components of assets' profitability (1)**

(percent of assets)




**Default and delinquency (2)**

(percent of portfolio)



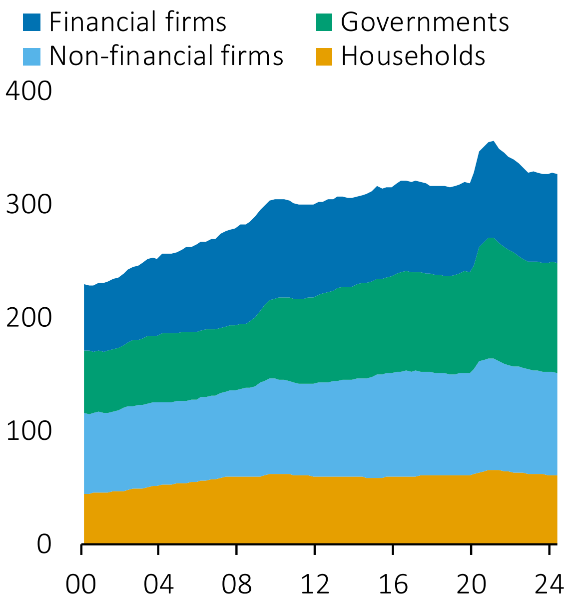

(1) Net income (the numerator for calculating ROA) corresponds to moving twelve-month sum. Mean ROA calculated from 2010 to date. (2) Preliminary results, subject to revision. Default is the C portfolio plus the default group portfolio.

Source: Central Bank of Chile based on CMF data.

Figure 12

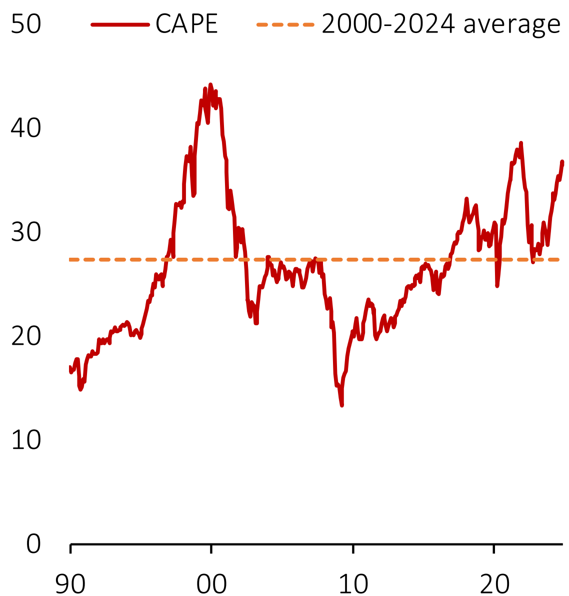
**Global debt**

(percent of GDP)




**CAPE Shiller ratio: U.S.**

(cyclically adjusted P/E ratio)

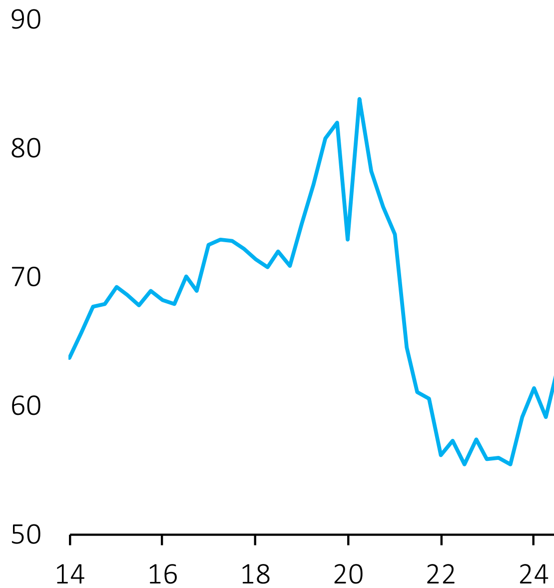



Source: Central Bank of Chile based on information from Global Debt Monitor database and Robert Shiller website.

Figure 13

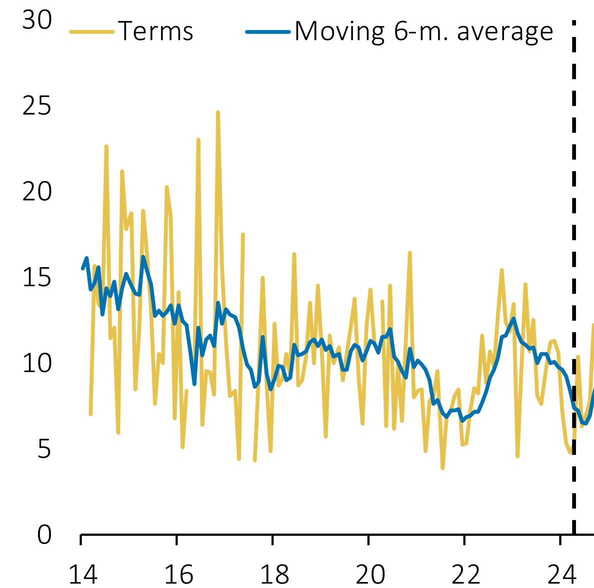
**Pension funds assets (1)**

(percent of GDP)




**Terms of UF-indexed bank and corporate bonds in local market (2)**

(years)



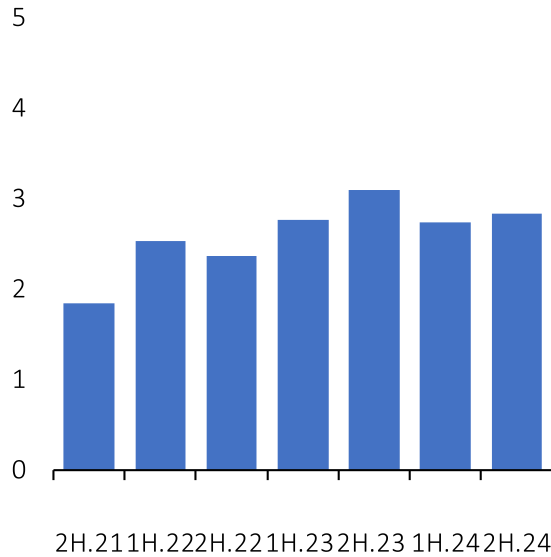

(1) Quarterly GDP at current prices is used, accumulating four moving quarters. The pension fund assets figure for 2024.Q3 are of the close of September. (2) Vertical line marks statistical close of previous IEF. Data aggregate uses monthly weighted averages.

Source: Central Bank of Chile based on information from the Santiago Stock Exchange, DCV, RiskAmerica and Pension Superintendency.

Figure 14

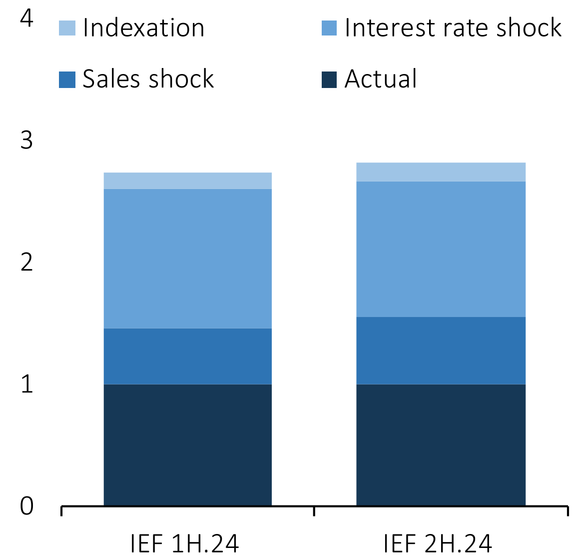
**Commercial debt at risk (1)(2)(3)**

(percent of GDP)




**Commercial debt at risk (1)(3)**

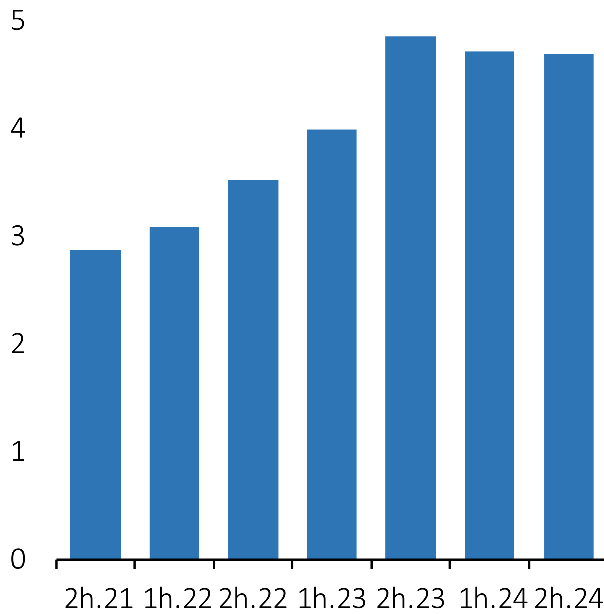
(percent of GDP, 2024)



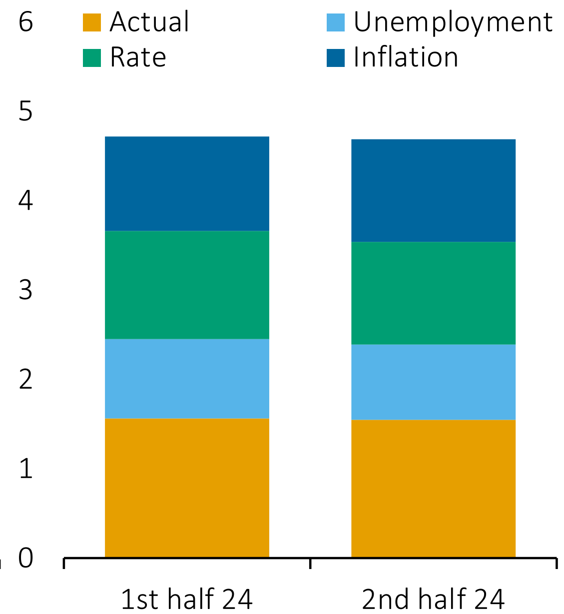

(1) Firms financed with local bank. Does not consider credit to persons. (2) Comparison is only for reference, due to GDP revision together with a shock of greater magnitude applied as from second half 2023. (3) Amount owed by each firm weighted by their individual probability of falling into default within one year.

Figure 15

**Households' debt at risk (1)(2)**
(percent of GDP)



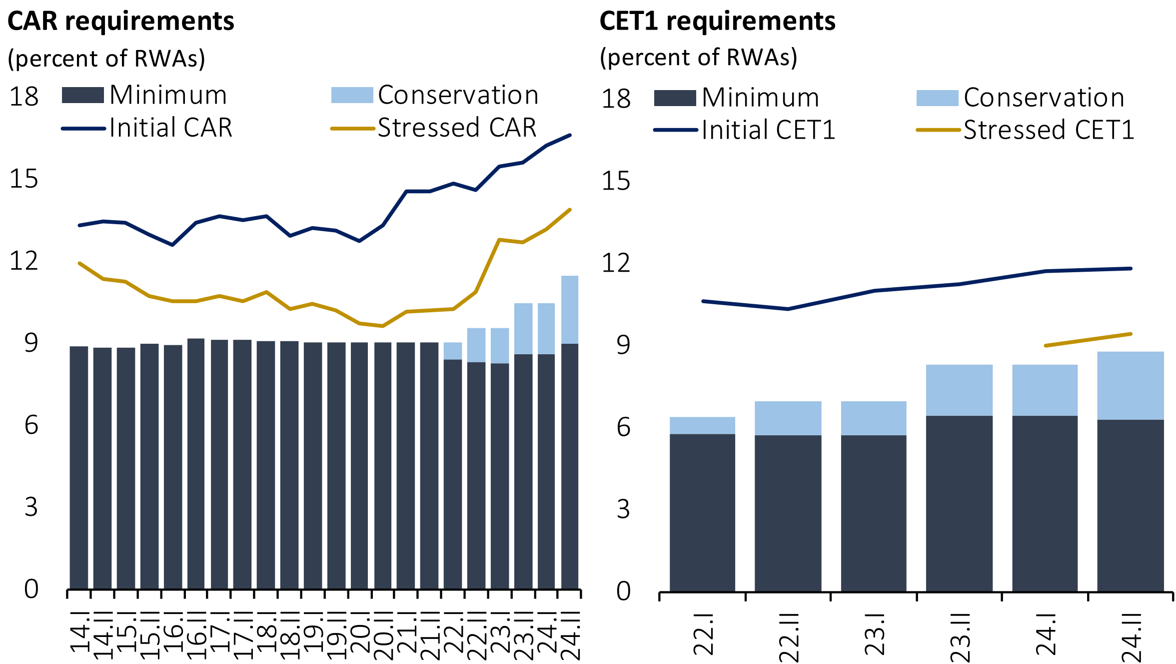

**Households' debt at risk (2)**
(percent of GDP)




(1) The comparison is only for reference, due to GDP revision together with shock of greater magnitude applied as from second half 2023. (3) Amount owed by each firm weighted by their individual probability of falling into default under a stressed scenario with a one year horizon.
Source: Central Bank of Chile based on CMF, Servel and SUCESO.

Figure 16

**Results of the system under severe scenario (*)**




(*) Capital requirements are calculated as the weighted average of the specific limits of each bank. The stressed scenario is assumed to release the prevailing CCyB at each moment.

Source: Central Bank of Chile based on information from the CMF and the Central Bank of Chile.