FINANCIAL STABILITY REPORT
Second Half 2018
Since the previous Financial Stability Report, the Chilean financial system, including its internal and external payment systems, has not recorded significant disruption events. In terms of risk, external financing conditions that are less favorable than those observed in recent years stand out. Local vulnerabilities and mitigators remain unchanged, being the flexible exchange rate regime one of the most relevant elements permitting to adequately absorb external shocks. In line with the previous Reports, the information available to date indicates that both debtors and lenders would be able to accommodate the impact of different aggregate stress scenarios, among other factors due to a low exposure to currency risk. All in all, some developments require further monitoring, among which stand out a potential abrupt change in external financing conditions, the smaller capital margin of local banks and the growth of non-bank credit in the absence of consolidated information about indebtedness.

Among the threats to financial stability, those linked to a sudden adjustment of external financing conditions continue standing out. Since the previous Report, the gradual process of monetary normalization in advanced economies has continued. The United States, Canada and the United Kingdom, among others, have gradually withdrawn their monetary stimuli; however, still remains the risk of a faster monetary policy adjustment in the US with respect to what is implicit in different market prices. Meanwhile, the European Central Bank has reduced bond purchases, intending to begin a gradual increase of its policy rate towards the end of 2019. In this context, long rates in Canada and the United Kingdom have remained stable since last May, while in the United States long rates showed an increase. There is also a risk of adjustment in appetite for risk of investors, which according to various indicators currently would be at high levels. This would lead to decompressions in risk premia and therefore abrupt changes in financial prices. In turn, in the emerging world, capital flows showed significant decreases during the year and in some economies financial conditions adjusted somewhat faster. For the time being, the main countries affected are those that had previous imbalances, such as Argentina, Brazil and Turkey.
In contrast, financing conditions at the local level in addition to risk premia for private issuers, continued to be favorable. Going forward, the deepening of adverse external events could have wider effects in emerging countries where the prolonged previous period of low rates incubated larger vulnerabilities. In the case of Chile, there are several mitigators, among others; a flexible exchange rate regime, and a deep local fixed income market, which translate into a low impact of changes in external financial conditions on local financial conditions. All in all, the higher equity reached by fixed-income mutual funds — made up of instruments that are more sensitive to changes in medium and long-term interest rates — has increased the potential effect a massive liquidation of their portfolios could have, when faced with a sudden increase in long-term interest rates.

In general, no significant financial vulnerabilities are observed among local companies. However, certain developments require a more detailed follow-up. Firms’ indebtedness would have reached 113% of GDP in the third quarter, with movements in recent quarters mostly explained by changes in the peso-dollar parity. This level of indebtedness does not necessarily represent a vulnerability due to important financial and currency risk mitigators. First, within the external debt (42% of GDP), loans related to foreign direct investment have a significant participation (17% of GDP) which has remained, these loans do not pose a level of financial risk equivalent to that of other sources of financing since they are financial obligations between related entities. Second, the firms that report to the Financial Market Commission exhibit low levels of currency risk exposure, due either to the composition of their balance sheets or the use of hedging instruments. Similarly, bond issuance in recent years has increased the duration of liabilities, therefore decreasing the risk of short-term refinancing. In particular, short-term residual external debt from loans (non-FDI) and bonds represents 3% of GDP. All these elements combined account for the low financial risk reported in stress test exercises carried out for the corporate sector. However, a potential vulnerability is configured for the group of local companies with investments in emerging economies — such as Argentina and Brazil — which could be affected by economic activity changes in these countries; nevertheless, their indebtedness with local banks is low. Finally, even though default levels have remained low among companies with local funding, firms from sectors related to the residential real estate market could exacerbate this situation, also affecting the portfolio of their creditor banks.

Household financial indicators have not shown major changes since the previous FSR. Debt continued to expand by over 7% in real annual terms. Since then, the deceleration of the mortgage component, which had been showing less dynamism since 2016 after a long period of higher growth, stood out. Meanwhile, non-mortgage debt continued to grow mainly through non-bank credit suppliers (NBCS), which represented close to 12% of total household debt by the second quarter of 2018. With respect to default, several indicators remained stable at low levels for historical patterns. In turn, between 2014 and 2017, the Household Financial Survey (HFS) reported a decrease in the number of households with debt, as well as an increase in those with savings. However,
among indebted households, the total median indebtedness increased from 1.6 to 3.5 times their monthly income, this was mainly explained by the fact that the representative household now has mortgage debt. This, together with higher obligations linked to revolving debt, resulted in an increased financial debt service ratio for the median household, which went from 20 to 25% of their monthly income in the same period. Moving forward, the evolution of the labor market will be relevant for the performance of the sector.

The main vulnerability of the banking sector is its lower capital margin with respect to the levels reached at the beginning of this decade. As discussed in previous FSR, stress tests have pointed out that banks have a sufficient level of capital to face a severe stress scenario, however over the last few years their financial slack has reduced. These capital margins will have to be improved under the implementation of the new banking legislation. Other elements that merit monitoring are the intensive use of collateral to hedge credit risk in the individual assessment commercial portfolio, as well as the indirect exposure to households that some banks have through the financing they provide to NBCSs.

This Report includes a thematic chapter on the residential real estate sector, which describes the main developments of the sector and their implications for financial stability. In the residential real estate market, multiple economic actors interact, among others: real estate and construction firms, households and banks. Therefore, its adequate development contributes to the financial health of the agents that participate in it. The chapter documents the recent evolution of the market and its main variables, establishing that it has grown without presenting major imbalances over time. In particular, bank funding of mortgages has become more important in the last 15 years. In this period, the mortgage portfolio went from representing 19% of bank assets to 28% by the second quarter of the current year. In addition, housing prices grew at an average real annual rate of around 5%, in line with higher income levels, relatively lower land availability, and the expansion of the rental market. Among the issues that merit more follow-up, the increase of retail investors in real estate stands out. While this element contributes to the development of the rental market, such investors are exposed to new risks arising, for example, from changes in both vacancy rates and house prices.

During the second half of the year, regulatory advances were consolidated, mainly in the convergence of banking regulation towards Basel III and towards strengthening the standards applicable to financial market infrastructures. During the second half of the year, the convergence of the Chilean legal and regulatory framework towards Basel III was consolidated, through the approval of a new General Banking Law and the incorporation into banking regulation of compliance requirements for short-term liquidity levels. In the area of financial infrastructures, the promulgation by the Central Bank of new regulation during last January, which increased and updated regulatory standards, has had a positive impact on the evaluations of international organizations. In August, the Bank enacted a contingency protocol for high-value payment systems in order to strengthen their operational continuity through the complementary functioning of the
subsystems that compose them in the event of critical operational events. In October, the Bank published for consultation the regulatory framework needed to establish an integrated derivatives information system that will be a repository of transactions and will be administered directly by the Central Bank, this will contribute to deepening this market. Other important normative advances correspond to regulations issued by the SBIF, on provisions for credit risk and cybersecurity matters.

Transactions through high-value payment systems increased, maintaining high standards of management and operational security, even during contingency situations. In particular, the real-time gross settlement system, which is administered directly by the Central Bank, has provided 100% availability while operating appropriately, even during contingency situations experienced by a local bank that required an extension of its normal hours of operation.