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RECENT AND PENDING FINANCIAL SECTOR REFORMS IN CHILE

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Agenda

- The subprime crisis: Crisis? What crisis?
- Financial sector lessons from the developing world: Believe it or not!
- Pending reforms: Not yet perfect.

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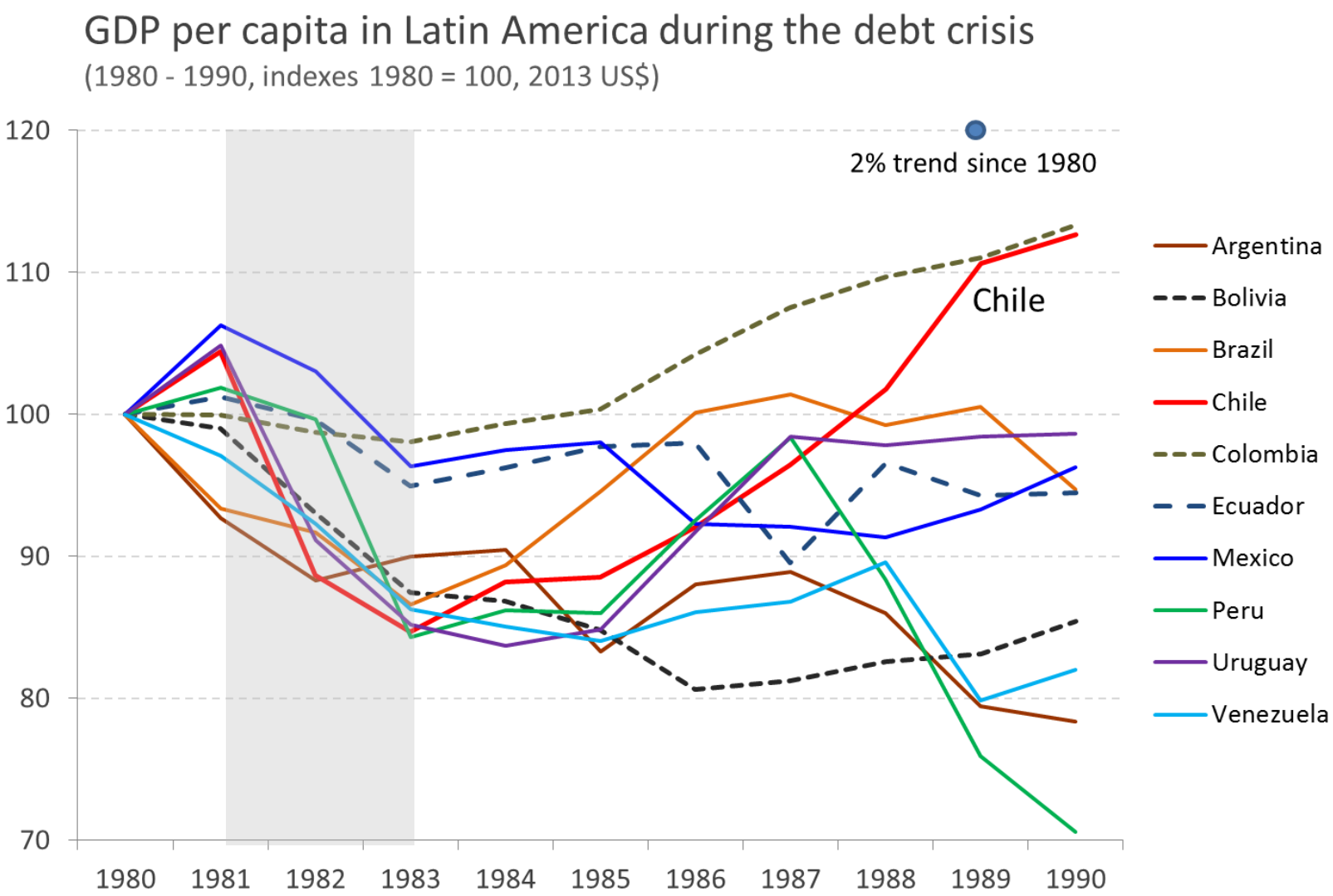
2008 and 1982:
Similar crises, different equilibria

A great story

Imagine a large and deep global financial crisis, second only to the Great Depression. What would be its impact on emerging countries? Disaster!

But this time it was different in Latin America.

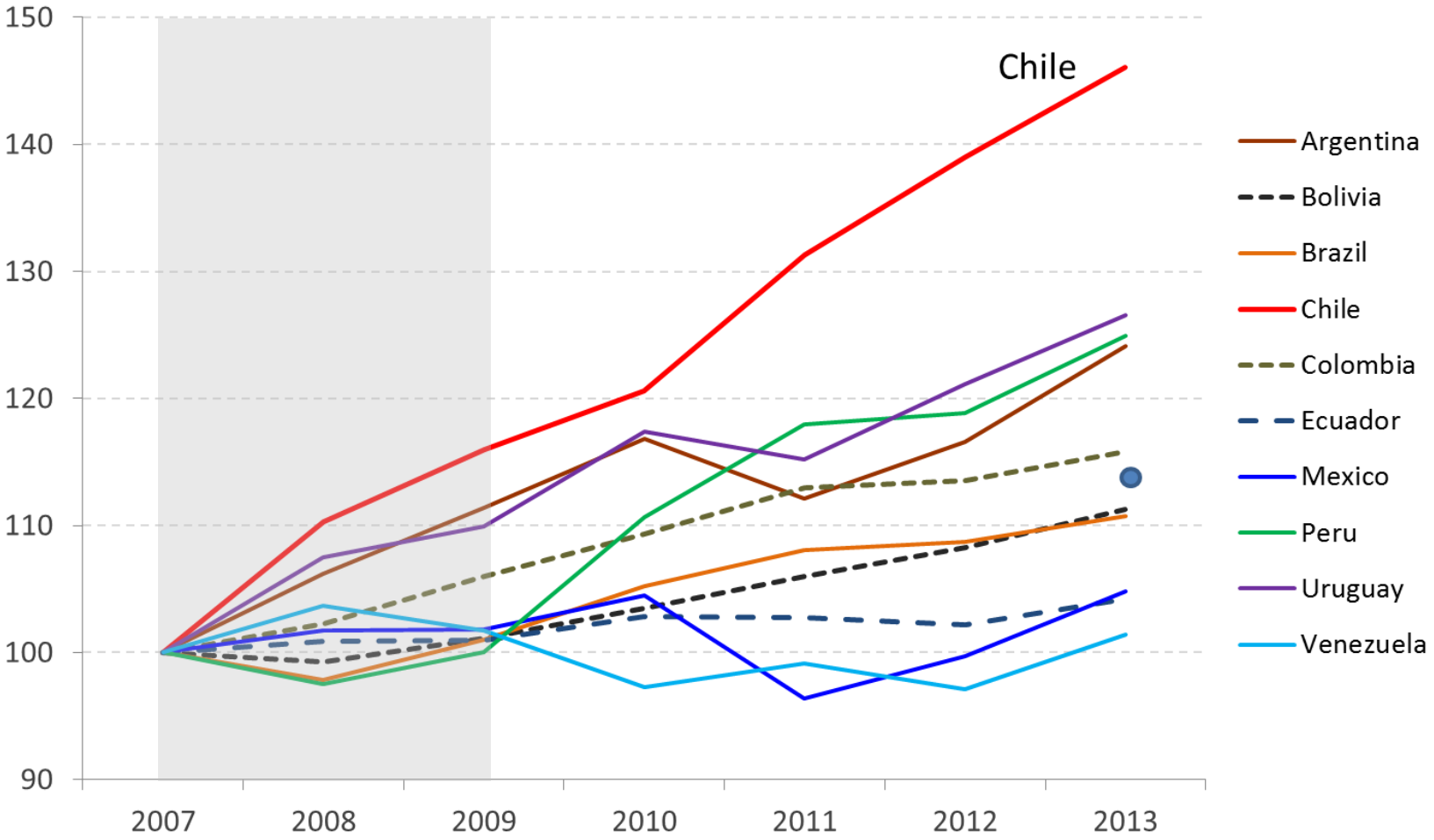
Why? Because Latin America learned the hard way when the countries faced their own financial crisis in the early 1980s.



Source: Data from The Conference Board Total Economy Database.

GDP per capita in Latin America during the subprime crisis

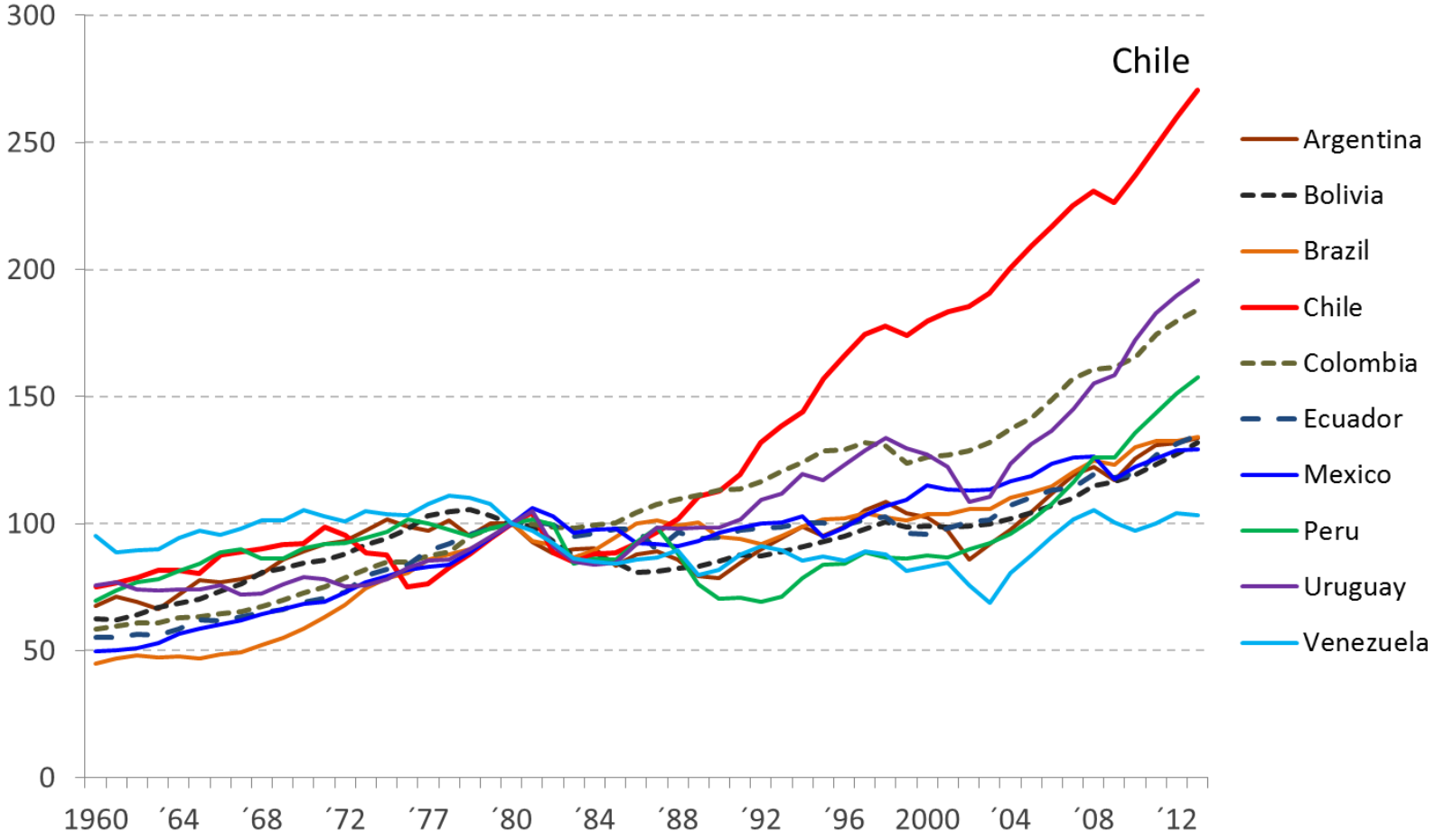
(2007 - 2013, indexes 2007 = 100, 2013 US$)



Source: Data from The Conference Board Total Economy Database.

GDP per capita pre and post "the model"

(1960 - 2013, indexes 1980 = 100, 2013 US$)



Source: Data from The Conference Board Total Economy Database.

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Learning from the developing world

Lessons from the subprime crisis

Risk in a financial system is more than an aggregation of risks in individual institutions.

Corollary: macroprudential policy is needed

But in Chile 2008 NO Financial Stability Board,
NO Basel II / III,
NO consolidated supervision of FC
NO stress testing, …….

……. <u>NO subprime crisis</u>

Congressional Research Service, Report RS22961
(WikiLeaks Document, 3/2009)

Information

Resolution

Credibility

Liquidity

"Chile experienced a banking crisis from 1981-84 that in relative terms had a cost comparable in size to that perhaps facing the United States in 2008-09. The Chilean Central Bank acted quickly and decisively in three ways to restore faith in the credit markets. It restructured firm and household loans, purchased non performing loans temporarily, and facilitated the sale or liquidation of insolvent financial institutions. These three measures increased liquidity in the credit markets and restored the balance sheets of the viable financial institutions. The Central Bank required banks to repurchase the nonperforming loans when provision for their loss could be made and prohibited distribution of profits until they had all been retired. Although the private sector remained engaged throughout the resolution of this crisis, **the fiscal costs were, nonetheless, very high**."

Markets

Moral hazard

Solvency

The main elements of the bank reform

Chile learnt the lesson of experience. And, at the end of 1986, as soon as the banking system's solvency had been restored, a comprehensive bank reform was implemented, in line with modern concepts of prudent regulation and effective supervision.

1. Industry entry requirements
2. Limits on lending to related parties
3. Loan classification and provisioning system
4. Effective supervision
5. Capital adequacy in line with Basel standards
6. Preventive and self-correcting safeguards
7. A limited guarantee or protection for deposits
8. Financial disclosure requirements
9. Corporate governance standards
10. A resolution mechanism

Congressional Research Service, Report RS22961
(WikiLeaks Document, 3/2009)

"Appropriate prudential supervision and regulation were critical for restoring health and confidence to the financial system. Observers lamented the a priori lack of attention to proper regulation."

Summarizing: after dealing with the initial financial panic, Chile **did** the homework …..

- Market determined interest rates that signal the right allocation of funding and level of risk taking.
- Tight regulations, with specific guidelines for the magnitude and types of derivative exposures and of securitization, and strongly limiting funding from related parties.
- Institutional commitment to individual risk management: Strong supervision, focusing on credit risk and provisions, and yearly *in situ* evaluations.

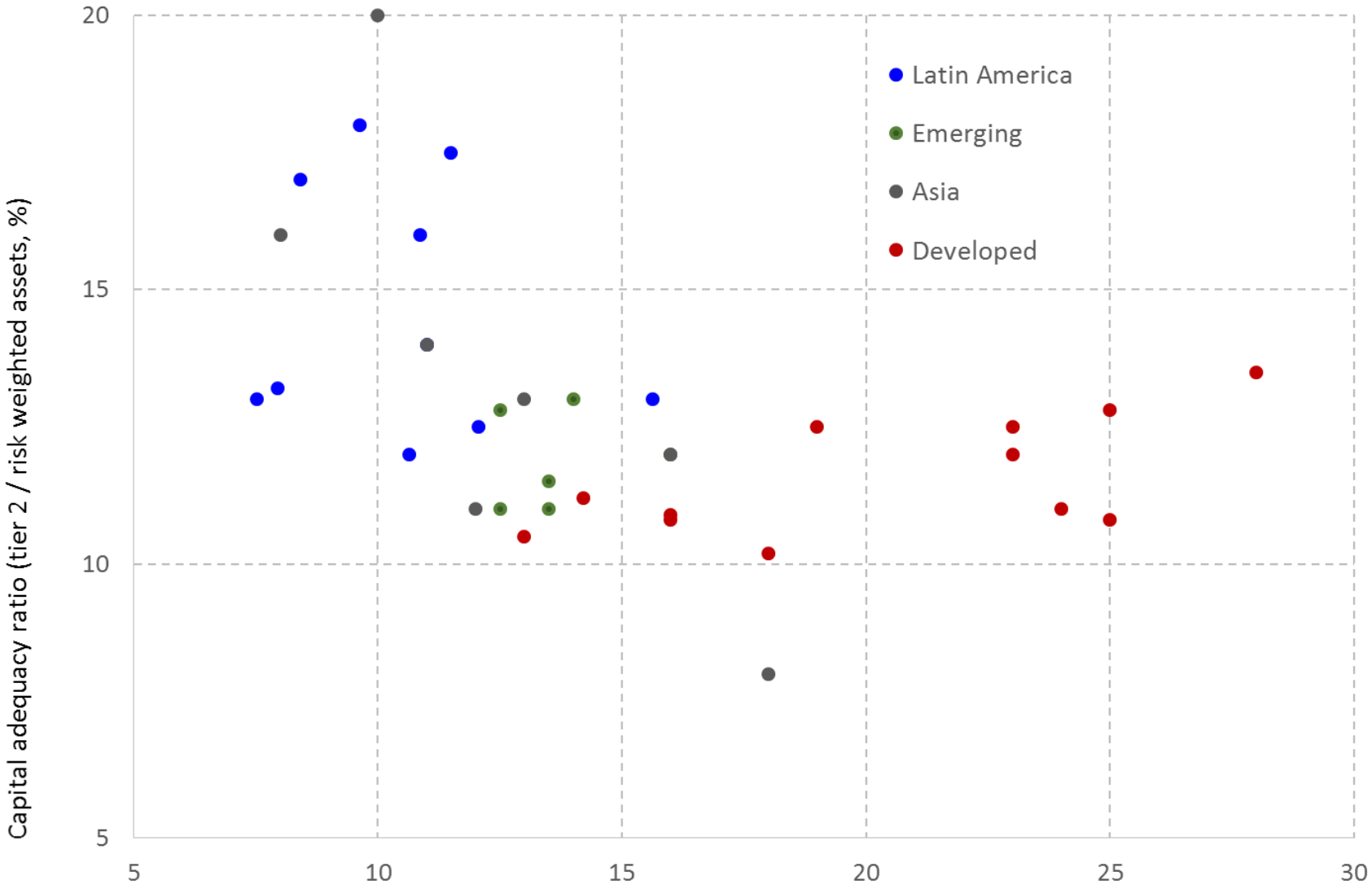
In addition, a sound macro policy framework (fiscal rule, inflation targeting, flexible exchange rate) and luck.

But several developed countries **did not** do the homework

- As in Chile in the early 1980s, the financial panic during the subprime crisis was a symptom of something broader and deeper — mainly a large overhang of private debt (this time, household debt).

- The Great Recession was mainly the result of a poor assessment of individual risk (inadequate risk management): lightly regulated non-banking institutions combining highly leverage and short maturity funding.

> "All financial crisis are brought about by the same circumstances: easy money, slack regulation, and blue skies thinking." (Christine Lagarde, 2011)



Leverage (Assets / Capital, times)

Source: IMF (2008)

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Some doubts: Policy implications and pending reforms

The policy implications: Some doubts (1)

1. Not everything Chile did may be implemented in the advanced economies, or even in Chile in the near future (new restrictions)

2. Not everything Chile did should be implemented when facing the next crisis (new opportunities)

The policy implications: Some doubts (2)

In Chile, the quantitatively relevant banks are large, boring, solvent and part of an economic conglomerate; highly efficient, but no so competitive.

But today, what also matters ……

Size

Public resources

Financial inclusion

Competition

Niche banks

Consumers

New technologies

New non banking credit providers

Pending reforms in Chile

Interest groups: Changes will be needed (or required), but there is a bias towards status quo, by the industry, and by the regulator as well.

And Chile still faces a number of policy challenges.....

……. consolidated supervision, to increase the supervision of all relevant non-bank retail credit providers, fostering of greater competition, a successful transition to Basel II/III, and formal rules on co-operation between financial market supervisors.

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