



Implementing macroprudential policies in Chile

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Introduction

- Macroprudence has gained notoriety in the analysis of public policies in the aftermath of the global financial crisis.
- It takes charge of problems that are not entirely new. It does take a new approach, however, and, above all, it provides innovative and constructive solutions.
- Certainly, the main challenge lies in the implementation, due to insufficient experience at the world level.
- Chile has not yet built a complete and consistent macro-prudential policy framework, but it has made steps in that direction.



Conditions for successful implementation

- First and foremost, a good diagnosis is needed on the state of regulation and supervision, including its strengths and weaknesses.
- This is essential for setting the right priorities. If weaknesses are identified at the microprudential level, the first priority will be to deal with them.
- It is also necessary to have a good evaluation of the financial system and its main vulnerabilities and risks.



Conditions for successful implementation

- In the case of Chile, there is significant agreement in that the regulatory and supervisory framework in place has made a positive contribution to financial stability over the course of the past 25 years.
- The main crisis episodes (i.e., the Asian crisis and the global financial crisis) have been overcome with no major setbacks.
- There is, however, a common perception that further improvement is needed.
- In this context, incorporating well-designed and consistent macroprudential policies becomes a challenge.



Governance for macroprudence

- Implementing macroprudential policies requires an institutional arrangement which is functional for that purpose.
- However, there is no one-size-fits-all or optimal formula that can be applied to all countries. There are several options that can be seen as reasonable or plausible.
- What is most important is to establish good mechanisms for coordination and communication among financial authorities; to ensure information is available to monitor risks; and to have skilled and experienced regulators and supervisors.
- One practical recommendation is to build up on existing institutional structure, avoiding duplication and overlapping.



Governance for macroprudence

- In Chile, two steps have been taken aimed at enhancing the institutional structure.
- The first one was the creation of the Committee of Superintendents. Its task has been to coordinate and exchange information in the specific field of control and supervision, which has allowed to make up for the weaknesses inherent to a sectoral supervision scheme.
- The second and more recent step has been the creation of the Financial Stability Committee (FSC), constituted by the Minister of Finance, who presides, the sectorial supervisors and the Governor of the Central Bank of Chile who is invited to attend meetings on a permanent basis, although is not a formal member. The functioning of this committee has been positively evaluated.
- As the idea of creating the FSC was debated, the possibility of endowing it with regulatory and even supervisory powers was considered but finally dismissed.



Role of the central bank

- This is a critical issue.
- Since their origin, central banks have been involved with financial stability.
- In the years leading to the crisis, an excess of confidence on markets' functioning and financial system's self-correcting capacity was incubated.
- As a result, some risks were overlooked. But the global financial crisis has brought back concerns over financial stability.
- The developments of recent years have also highlighted the close interrelations that exist between price stability and financial stability.
- For all these reasons, it seems essential for the central banks to be front-line players in the implementation of macroprudential policies.



Role of the central bank

- Specifically, the Central Bank of Chile (CBC) is well prepared to take on responsibilities in this area.
- Its mandate is in perfect harmony with the concept of macroprudence.
- It already has multiple regulatory powers relating with financial stability and systemic risks. Those powers cover different matters and reach different players in the market (banks, savings and loans cooperatives, pension funds, etc.).



Role of the central bank

- The CBC conducts monetary policy which has a close relation with macroprudence. In addition, as is typical of emerging economies, it has authority to define the exchange rate regime, apply capital controls, intervene the foreign exchange market and accumulate international reserves. The exercise of such authority has also ties with macroprudence.
- At the institutional level, the CBC meets the requisites of internal governance and autonomy which seem necessary for conducting macroprudential policies.



Role of the central bank

- It has taken steps to strengthen its analytical capacity:
 - It created a new division with the same status as the monetary policy division for financial stability monitoring and regulations.
 - It launched the publication of the Financial Stability Report.
 - It began performing stress tests for the banking system and it plans to extend them into other relevant sectors (e.g., life–insurance companies).
 - It began conducting a household financial survey.
- Concerning regulation, it has been proactive in taking action to enhance financial stability.
 - It incorporated to the regulatory perimeter non–bank credit card systems (the decision was adopted jointly with the supervisor).
 - It played an active role in enhancing regulations for money market mutual funds.
 - It took part in setting the regulations of the recently created center counterparty clearing system for financial securities.



Role of the central bank

- As a consequence, the CBC has to play a leading role in the implementation of macroprudential policies.
- There are, however, aspects or issues that need improvement or reforms for such role to be fully met.
- The CBC must become a more active participant in the definition of prudential regulations, particularly in matters relating with capital requirements and loan-loss provisions.



Role of the central bank

- Furthermore, some pieces of regulations, currently enacted by law, should become subject to the regulatory power of the CBC and/or the corresponding supervisor, among other reasons because some discretion seems necessary for implementing macroprudential policies.
- This could be done by demanding the simultaneous approval of the supervisor and the CBC for setting such rules. This mechanism is currently being used and has proved efficient.
- Another issue that must not be overlooked is the potential implications of macroprudential policies on the CBC's balance sheet and, ultimately, on public resources. This necessarily calls for proper coordination with fiscal authorities.



Macroprudential instruments

- Selecting instruments is also an important task, but the challenge does not end there because how and when they are applied can make an enormous difference.
- Practical considerations are essential when choosing instruments. Of course, they must bear a close relation to the risks and vulnerabilities actually observed in the financial system.
- Consequently, emerging economies will have to pay attention to certain elements that frequently characterize their financial systems: dollarization, currency mismatches in financial intermediaries and their corporate clients, foreign dependency for the funding of banks and firms, and the presence of foreign bank subsidiaries with a high stake in the domestic market.



Macroprudential instruments

- The distinction between cross-section and longitudinal-section (countercyclical) instruments is appropriate for the analysis.
- Typically, cross-section instruments are relatively well known and have been used, with varying intensity, in the field of microprudence.
- In principle, implementing them poses no special or extraordinary challenge.
- In any case, macroprudence will require using them with a much more proactive approach than has been the standard, meaning that they will have to be periodically checked and re-calibrated in the light of the accumulated experience.



Macroprudential instruments

- Chile exhibits some familiarity with this type of instrument.
- There are rules, in effect since before the global crisis, that allow raising the capital requirements to larger banks from 8% to 14%. There is also a long-standing tradition in the application of liquidity and currency matching rules. As regards the presence of foreign banks, there are rules that reduce the probability of contagion from the parent-company to the subsidiary.
- Certainly, introducing a macroprudential framework will call for improvements to the regulations in force and the establishment of complementary ones.



Macroprudential instruments

- However, the novelty in macroprudence lies in the countercyclical instruments, including capital buffers like the ones recommended by Basel III, contingent convertible bonds (CoCo bonds) and dynamic provisions.
- Implementing this type of tools does pose important challenges.
- A critical issue is defining operational criteria (triggers) for the accumulation or depletion of safety buffers. There are several options, each with its pros and cons. One possibility is to set criteria on individual bases, which ensures a better correspondence between a bank's actions and its financial situation, but that requires good supervision.



Macroprudential instruments

- Another option is to set the criteria based on the behavior of certain financial or economic aggregates that reflect the cyclical position of the economy. These would have a clearly more countercyclical imprint, but their application might create tensions with other public policy objectives.
- In any case, certain degree of discretion in the application of these instruments seems necessary. Setting fixed or rigid rules may be counterproductive.
- Granting discretionary powers may encounter some resistance in jurisdictions having no tradition in doing so. In Chile, the solution that has been explored to overcome such apprehension is to use a system of checks and balances for the exercise of certain regulatory powers.



Macroprudential instruments

- When macroprudential policies are implemented, however, authorities can not miss the point that their main objective is to prevent systemic crisis and not to avoid economic cycles.
- Emerging economies have used credit risk provisions as a key instrument for regulation and supervision, reflecting the existence of risks and spreads higher than those commonly observed in advanced countries.
- A robust provisioning scheme, regardless of any countercyclical imprint, is by itself a macroprudential instrument which has multiple advantages. It favors good credit management (because it aligns decisions with results) and it strengthens market discipline (because it forces accounting values to approach economic values).



Macroprudential instruments

- Accordingly, the option of improving the provisioning rules, giving them a dynamic or countercyclical imprint, appears simple and interesting. Some countries in this region have already taken steps in that direction and close attention must be paid to their experiences.
- When Basel II was being discussed, the convenience of making provisioning the fourth pillar of the accord was brought up, but this idea was rejected by developed countries. This key role of provisioning arises again as countercyclical policies are being discussed.
- It is important to keep in mind, additionally, that implementing any scheme of countercyclical capital may be difficult in economies not having deep enough capital markets.



Macroprudential instruments

- Macroprudential policies must necessarily be complemented by resolution mechanisms that help minimize costs once the risks have materialized. Short of that, any macroprudential framework would be incomplete.
- Chile, for the past 25 years, has had resolution mechanisms in place for banks, that start operating before insolvency is evident, which seems highly advisable.
- However, these mechanisms have not been tested in scenarios of extreme stress, so there are apprehensions regarding their application under such circumstances.



Macroprudential instruments

- Furthermore, the growing presence of institutional investors that hold significant deposits and investments in the banking system has painted a different picture from the one that existed when these mechanisms were first devised.
- It must be kept in mind that these investors are regulated and supervised, and that their obligations have certain guarantees from the State.
- This scenario, which is also present in other countries in the region, poses a challenge for the definition of resolution mechanisms.



Supervision & macroprudence

- Supervision must be incorporated into the analysis.
- No regulation is good if it lacks effective supervision.
- Many deficiencies observed in our countries are related to supervision rather than regulation.
- Regulation and supervision may be in charge of different institutions. What matters is that they both play their roles efficiently.
- In the implementation of macroprudential policies, supervision can make significant contributions at various phases or stages:
 - In early identification of risks and vulnerabilities.
 - In the evaluation of the practical effects of the proposed actions.
 - In the phase of policy execution.



Supervision & macroprudence

- In Chile, the bank supervisor made contributions like these in the past.
- In the 1990s, it enacted regulations that required setting provisions for consumer credits taking into account the payment history of the customer not only in the institution involved but also in the banking system at large.
- In the early 2000s, following suggestions made by the Ministry of Finance, it set up guidelines telling banks to consider in their risk assessments and provision policies their customers' currency mismatches.
- Both pieces of regulations were motivated by systemic risk considerations.



Implementation risks

- Generating disproportionate expectations regarding macroprudence. Thus, realistic objectives must be set, and clarity must exist about what is understood by systemic risk.
- Extending the regulatory perimeter beyond what seems reasonable or granting the same regulatory treatment to institutions with different systemic implications.
- Going too far with the concept of macroprudence. This may occur if it ends up being used to cover or justify different types of action, including macroeconomic policy measures adopted under different circumstances and with different goals.
- Causing unintended adverse effects on efficiency, competition and market discipline.



Final remarks

- The global financial crisis has highlighted the need to incorporate a macroprudential dimension in the regulation and supervision of the financial system and in macrofinancial policies in general.
- Nevertheless, significant conceptual and operational challenges are associated with the implementation of those policies. The biggest complexity is in the countercyclical instruments.
- Macroprudence involves tasks to be performed by both central banks and supervisors.



Final remarks

- In Chile, the regulatory and supervisory framework has contributed positively to financial stability, but adjustments and improvements are still required, including the incorporation of well-designed, consistent macroprudential policies.
- The recent creation of the FSC is a very positive step in that direction.
- The Central Bank of Chile should assume a leading role in the design and implementation of such policies and is well prepared for doing so. It is in harmony with its mandate, its powers and the effective commitment it has shown with financial stability.



Final remarks

- However, there are aspects or issues that need improvement.
- From that perspective, it is crucial for the CBC to become more involved in defining prudential regulations.
- In addition, certain rules enacted by law should become subject to the regulatory power of the CBC and/or the respective supervisor, which would imply increased flexibility for the application of macroprudential policies.
- The formula of demanding the simultaneous approval of the CBC and the respective supervisor has worked well to set certain regulations, and could be extended into the scope of macroprudence.