

# Enrique Marshall: Central banks' contribution to financial stability – the experience of Chile

Speech by Mr Enrique Marshall, Board Member of the Central Bank of Chile, at the Central Bank of Bolivia's First Financial Workshop "Macroregulation and Financial Stability", La Paz, 29 September 2010.

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## 1. Introduction

Financial stability has been a concern for central banks since their very origins. The functions for which they were created – to regulate money and credit markets and to serve as lenders of last resort – have a direct bearing on the objective of financial stability and this relationship has been further reinforced by the fact that many central banks have also undertaken a role in regulating and supervising the banking system.

Both the economic literature and historical experience provide sound grounds for this concern for stability, clearly demonstrating that the functioning of the real economy requires an efficient and stable financial system. The hardest lesson of history, however, is that financial crises have occurred time and again, with a very high cost in terms of both their fiscal impact and the associated losses of output.<sup>1</sup>

Financial stability has, as a result, emerged as a paramount objective of public policy. However, the transformation of this general intention into specific objectives and policies has been, and remains, a complex matter that often involves options or dilemmas that are not always easy to resolve.

To start with, the concept of financial stability is difficult to define precisely, nor do we have a sufficiently solid analytical framework equivalent to that used to conduct monetary policy. Moreover, responsibility for preserving stability is normally shared among different authorities, each with its own approach to the issue.

As a result of the current global financial crisis, financial stability is very much at the center of debate, prompting an in-depth review of institutional arrangements, authorities' responsibilities, policies and the instruments that can be used for this purpose. In developed countries, where the crisis had its origin, financial reforms are underway in a bid to overcome the weaknesses that were detected. Emerging economies, although they did not experience the same problems, must take advantage of the opportunity to review their own situation, draw lessons and advance in perfecting their financial systems. From this point of view, the exchange of opinions that is the purpose of this seminar may help in drawing up recommendations.

## 2. The Central Bank of Chile and financial stability

The concern of the Central Bank of Chile (BCCH) for financial stability is anchored in its legal responsibilities and the powers or instruments assigned to it. An organic law in force since 1989 establishes that the BCCH's objective is to "safeguard the stability of the currency and the normal functioning of domestic and external payments".

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<sup>1</sup> See Table 1 at the end of this document.

The first part of this objective is interpreted as the maintenance of price stability or, in other words, low and stable inflation. For the past ten years, the BCCH has applied a policy framework with an inflation target of 3% and a 1% tolerance range.

The second part of its objective is directly related to financial stability. For payments to be made normally, the banking system, money and credit markets and supporting infrastructure must all function properly. The reference to external payments seeks to highlight the importance that trade and financial flows with the rest of the world have for an open economy such as Chile. Financial stability is, in other words, an essential part of the BCCH's responsibilities, very much in line with what we see in most of the world's economies.

In the eyes of BCCH, the two parts of its objective are different and separable, but affect and reinforce each other. The management of monetary policy, which seeks price stability, requires that money and financial markets work well while financial stability requires, among other conditions, that inflation remains low and stable. The recent financial crisis has underlined the interrelations between these two objectives.

The powers with which the BCCH is endowed also have a clear relation to financial stability. The BCCH can provide the system with liquidity under normal terms and conditions and, although forming part of the management of monetary policy, this simultaneously fulfills functions related to financial stability. Liquidity can also be provided in extraordinary circumstances and the BCCH is empowered to make emergency loans to banks suffering temporary liquidity problems. Moreover, if a bank is forced into liquidation, the BCCH must provide the funds to pay deposits guaranteed by the State, which include all sight deposits and those of small savers.

In addition, the BCCH has powers to regulate the money market and the system of payments. It establishes norms for deposits and bank borrowing and regulates the working of large-value clearing houses and payment systems and also has some powers of prudential regulation. It regulates market risks and relations between banks' active and passive operations as well as the operations of saving and loan cooperatives and bank and non-bank credit card systems. On these same lines, it sets some norms with systemic implications that refer to pension fund investments such as, for example, the percentage of their portfolio that they may invest abroad. In addition, it participates in some decisions in the sphere of prudential regulation for banks, issuing a prior opinion or giving its agreement.

For prudential reasons, the BCCH can impose restrictions on foreign exchange operations. In the case of foreign trade, it can require the repatriation and liquidation of export revenues and set a term for import coverage while, in the case of financial flows, it can impose reserve requirements as it, in fact, did in the 1990s.

The BCCH is also authorized to accumulate and maintain international reserves. This has a direct impact on the country's international liquidity position and, in the last instance, on the stability of cross-border financial flows and, therefore, the normal functioning of the domestic financial system.

Since the BCCH's origins, banking regulation and supervision have been entrusted to the Superintendency of Banks and Financial Institutions (SBIF) which depends on the government through the Finance Ministry. There is also a supervisor for securities and insurance and for pensions. This institutional arrangement has, in general, worked well over the years. In order to ensure the necessary coordination and communication between the different authorities, a committee was created a few years ago that brings together all the financial sector supervisors and in which the BCCH also participates. It has allowed the BCCH to make its view on issues of systemic importance known to the supervisors.

Numerous initiatives implemented by the BCCH over the past decade underline its firm commitment to financial stability. These include:

- a) creation of a large-value payment system based on real time gross settlement (2004);

- b) publication of a Financial Stability Report as from 2004;
- c) stress tests for the banking system and disclosure of their results which are published in the Financial Stability Report;
- d) incorporation of non-bank credit card systems into the regulated system, although with looser norms than those applying to banks (2006);
- e) implementation of a household financial survey, carried out countrywide for the first time in 2007 and followed by panel studies for Greater Santiago in 2008 and 2009, gathering information that has served as the basis for numerous research projects;
- f) participation, along with other authorities, in an initiative to modernize the system for clearing and paying financial securities, which will lead to the creation of a clearing house and central counterparty in line with international standards (2009–10).

During the recent crisis, the BCCH was decisive in exercising its powers as regards financial stability and these proved effective in maintaining the normal functioning of the system. In April 2008, it announced a program of accumulation of international reserves for US\$8 billion with the aim of strengthening the country's international liquidity position in a context of great uncertainty about the outlook for the international economy and a significant appreciation of the Chilean peso. This measure was successful in achieving its objectives. Subsequently, due to the intensification of the crisis in September/October 2008, the BCCH took extraordinary measures to provide liquidity in pesos and dollars and ensure the normal functioning of the financial system. Through these measures, it was able to dissipate internal financial tensions and bring about a fairly quick return to full normality.

Compared with other central banks, the BCCH faces some limitations in managing situations of tension or crises. It is expressly forbidden to provide financing, directly or indirectly, to the government and state institutions or enterprises. It cannot, therefore, acquire securities issued by the Public Treasury as part of its monetary operations. This does not, at present, represent a significant restriction because these operations are carried out using the BCCH's own securities but, in a critical situation, could limit its ability to inject liquidity into the system. Similarly, it can only provide liquidity to banks and cannot intervene directly in the financial markets by buying securities from other types of institutions or investors, nor can it make direct or indirect capital contributions to institutions in difficulties.

However, the BCCH has not been alone in seeking to ensure financial stability. Fiscal policy, prudential regulation and banking supervision have also made a very positive contribution.

Fiscal policy has, in general, been noted for its responsibility during this period. Moreover, since 2000, the government has applied a policy rule that sets effective spending as a function of permanent fiscal revenues. This has made fiscal policy predictable and sustainable over time as well as making it possible to keep public debt low. Indeed, thanks to a significant increase in copper revenues, this has dropped to a historically low level in recent years and gross central government debt is currently running at around 6% of GDP. All these factors have contributed to financial stability.

Prudential regulation has been another key pillar of financial stability. It was completely redesigned after the severe financial crisis of the 1980s. The lessons of this crisis were learned and then incorporated into banking law and, although this has since been subject to updates and modernization, it has maintained the hallmark strictness it acquired in this period.

Some of the recommendations put forward in the light of the recent crisis have, in fact, been part of Chilean regulation for some time. For example, it includes:

- a) regulatory incentives for banks to maintain capital in excess of the required minimum so that their effective capital represents more than 10% of their risk-weighted assets;

- b) prudential standards to preserve the quality of capital (hybrid instruments cannot exceed 50% of basic capital);
- c) explicit limit on gross leverage as a complement to capital adequacy rules based on Basel recommendations (basic capital cannot be less than 3% of total non-weighted assets net of required provisions);
- d) special regulatory requirements for larger banks (capital requirement can reach 14%);
- e) robust provisions regime with a forward-looking approach;
- f) quantitative norms on the match of the terms and currencies of banks' assets and liabilities;
- g) preventive capitalization, regularization and resolution systems for banks in difficulties.

Supervision has also played a key role. In recent decades, this evolved from a formal and passive approach to one that is significantly more intrusive and proactive. Supervision now focuses on the governance and, above all, management of institutions. Supervisors seek to be familiar with all the aspects or issues that can be important in an institution's behavior, rather than merely verifying compliance with regulation or simply reviewing financial indicators from previous years. The ultimate aim is to induce changes or corrections in the management of an institution when weaknesses are detected. This approach, known in the literature as risk-based supervision, is the one that has been recommended in the light of the recent crisis.

On several occasions, supervision has ventured into what is today termed macroprudence. At the end of the 1990s, the SBIF issued recommendations urging that due attention be paid to the concentration of risks in the real estate sector, beyond what each institution might have on its books. Applying this same logic, it also issued instructions for the treatment of lending to individuals, particularly consumer loans, in the context of the rapid growth of these operations. Then, in the early 2000s, it instructed supervised institutions to carefully assess their clients' exchange-rate risk, regardless of whether their own positions were well hedged. When mergers and acquisitions intensified a few years ago, it also took the initiative of introducing stricter regulation for banks of a larger relative size so as to guard against systemic risks.

Although a factor of a different nature, the development of Chile's capital market has also contributed to financial stability. The creation of a private pension system brought with it the appearance of institutional investors as well as new sources of medium and long-term financing. At the end of 2008, when international markets became tense, Chilean companies were able to replace external financing with placements on the domestic market on convenient terms and conditions.

### **3. Remarks in the light of recent experience**

The paramount objective of central banks has been and will continue to be price stability. Recent decades have brought notable achievements in this area. They were possible thanks to the institutional strengthening of central banks, including statutes of autonomy and advances in the design, implementation and communication of monetary policy. It is important to persevere on these lines whilst also bearing in mind possible adjustments or improvements.

Central banks, however, also have an important responsibility for financial stability. Although this responsibility had lost prominence over time, the experience of recent years has clearly underlined its importance. Moreover, because of their monetary policy tasks, they are in direct contact with the markets and, therefore, have access to first-hand information about

the functioning of the financial system. This puts them in a privileged position to undertake tasks related to financial stability.

Central banks must, however, be realistic in setting their objectives. It is critical to ensure that they do not result in a more than reasonable level of protection for the financial system since this would encourage banks and other financial institutions to take excessive risks. The responsibility of central banks as regards financial stability must be geared principally to strengthening the reaction capacity of the system as a whole. If problems occur in specific institutions – which cannot be ruled out – the aim must be to minimize their systemic impact.

Central banks must have a set of instruments that allow them to contribute effectively to financial stability. Many of these instruments, such as providing liquidity, are inherent or traditional while others, such as regulating and watching over payment systems, have developed in recent decades. The experience of the last few years has suggested a need to review or update the available instruments and to generate the operational conditions in which they can be used without delay when needed. During this latest crisis, for example, many central banks were not operationally prepared to receive collateral that was not in habitual use. It has also been suggested that there is a need to incorporate new instruments, principally with a macroprudential approach. However, in the case of some of these instruments – specifically, the use of regulation for countercyclical purposes – evidence is scarce and debate as yet inconclusive.

However, beyond the contribution that a central bank can make, financial stability requires a comprehensive framework of financial institutions, policies and practices. The solidity of this framework and its consistency are crucial. Regulation and supervision, whether or not in the hands of the central bank, are critical, but so too are monetary and fiscal policy. The recent sovereign debt crisis in Europe, for example, has demonstrated the importance of fiscal conditions for financial stability.

Market discipline and institutions' management, although discredited by the crisis, are factors that can, with an appropriate regulatory framework and incentives, contribute to stability. The efficiency of regulation and supervision should, in the end, be reflected in good behavior by institutions and the proper functioning of markets.

Discussion as to the institutional arrangements that are most appropriate from the point of view of financial stability remains open. One key question is who should be responsible for the tasks of prudential regulation. Another, although perhaps slightly less important, is who should do the supervision. There are arguments in favor of different policy options, but any specific recommendation must take into account the experience and circumstances of each country. Until the crisis, the prevailing trend was for a body different from the central bank to be responsible for regulation and supervision whereas now the wind seems to be blowing in the opposite direction. In this context, one piece of practical advice is not to significantly change something that has worked well.

In any case, the decisions that are taken may have significant implications for central banks' institutional insertion, the scrutiny to which they are subject, and internal organization of their activities. These implications become particularly important if it is decided to give the central bank broad responsibility for financial stability. In this case, it may be advisable to adjust internal governance so as to ensure the necessary separation of the objectives of financial stability and price stability.

Under any institutional model, coordination and communication between the different authorities with functions related to financial stability will always be very necessary. Even under a model that assigns all the relevant functions to the central bank, coordination and communication between it and the government will still be essential because it is the fiscal authority that is responsible for the use of public resources. In a globalized world, it is, moreover, necessary to develop mechanisms for coordination and communication with the authorities of other relevant jurisdictions. In many emerging economies, this is a key issue because of the significant presence of international banks in these markets. In addition,

stronger coordination and communication between authorities is vital for progress towards comprehensive or consolidated supervision of financial groups and for avoiding some of the problems detected in the recent crisis.

One recommendation on which there is fairly broad agreement is to periodically review the perimeter of regulation and supervision. The traditional view that this should include only institutions taking deposits from the public has been superseded by events. The consensus view that has emerged from the recent crisis is that all institutions of systemic importance must be regulated and supervised. This also includes the obligation to provide information and disclose positions in order to ensure that markets function properly. The practical implications of this recommendation may vary from country to country, depending on the characteristics of their financial systems.

There is also broad consensus that minimum capital requirements, applied on permanent bases, must be raised and strengthened as stated in the recent agreement reached by the Basel Committee. However, the recommendation that a capital component of a countercyclical nature be introduced raises a number of questions. What does seem interesting, although it is not explicitly included in the recent Basel proposal, is the idea of having some component of contingent capital. This could be established by issuing bonds that would, under certain circumstances or conditions, become capital as, for example, if an institution's capital falls below 8% of its risk-weighted assets.

Another point on which there is a considerable agreement is the need to review norms and practices on liquidity management and bank funding. These had become quite lax in many jurisdictions. Liquidity and refinancing risks were underestimated, particularly in the environment that preceded the crisis. The recommendations that have subsequently been put forward include a redefinition of liquid assets, the establishment of a minimum global liquidity standard, norms using time bands for the match of assets and liabilities, and higher requirements for liabilities that show greater volatility. In all these cases, there is much that central banks can contribute. The Basel Committee has recently undertaken to advance in defining a global liquidity standard and has fixed a calendar for this process.

A robust system of provisions, based on a forward-looking rather than a backward-looking approach, can make a significant difference to the stability of the banking system. This is illustrated by the experience of emerging economies where this policy instrument is used most often and with the greatest intensity. During discussion of the Basel II agreement, it was suggested that provisions should be its fourth pillar but this idea was, in the end, rejected by the developed countries because of potential conflicts with accounting norms. After the crisis, there is, however, renewed interest in provisions as a prudential instrument. The idea of applying some countercyclical rule has gained ground. Several Latin American countries have advanced in this direction and their experience should be followed with attention.

Mortgage operations, which are very closely related to the origins of the crisis, will need to be reviewed. The volumes and amounts committed to this activity are growing and have, without doubt, acquired systemic importance. This has implications both for the banking system, where these operations tend to originate, and for the securities market which provides the financing. The recommendations that warrant attention include the application of a prudent loan-to-value ratio taking into account cyclical fluctuations in the price of the dwelling, stricter requirements for institutions in the business of originating to sell, and the use of covered bonds to finance these loans so as to leave credit risk in the hands of the issuer while transferring market risk to the investors. This latter recommendation is backed by several successful experiences including that of Chile with covered bonds.

Because the origins of the recent crisis appear to have been closely related to lax credit policies in the personal banking segment, commercial practices that lacked transparency and excessive household borrowing, it has brought the issue of consumer protection to the fore. Although also a broader issue, consumer protection is related to the proper functioning and stability of the financial system, particularly if it is understood to include such important

matters as financial education, transparency with clients and market behavior, It can, therefore, not be ignored when deciding within which institutional framework and with what policies to address this issue.

#### **4. Final remarks**

Concern for financial stability is at the origin of central banks. It can, in fact, be said to be in their DNA. Although this concern had faded over time, the experience of recent years has again brought it very much to the fore. As a result, there is now broad agreement that central banks have an unshirkable role in this field and debate centers rather on the instruments they need to have.

The crisis has left important lessons, especially for the developed economies where it had its origins. They have already begun to implement financial reforms in a bid to remedy the weaknesses that were observed. The emerging economies, although they did not experience the same problems, must take advantage of this opportunity to review their own situation, to draw lessons about what worked well or not, and to advance in the task of perfecting their financial systems.

Chile's institutional arrangements as regards financial stability have generally worked well in recent decades. This is borne out by the present strength of its financial system and the way in which it came through the recent crisis without major problems. But there are pending tasks and challenges. Large financial reforms may not perhaps be required but there is room for improvements in various areas. They include the need to create a mechanism for coordination and communication at the highest level with a focus on financial stability in which the government, the BCCH and the different financial sector supervisors participate. This would allow the BCCH to make its points of view known formally to the relevant authorities.

Similarly, in a context in which financial activities have become increasingly complex, the bodies responsible for supervision need to be strengthened institutionally. From this point of view, particular attention should be paid to the resources assigned to them and their capacity to issue norms and regulation in a world that calls for constant adjustments and changes. Finally, it would be advisable for the BCCH to have a more active role in defining prudential regulation. In some cases, this role already exists but could be extended to other norms with systemic implications. For coordination with the SBIF, a mechanism similar to that which already exists requiring a prior report or authorization from the BCCH when the supervisor exercises its regulatory power, could be used.

Table 1

## Comparative costs of different financial crises in developed and emerging economies

Country	Period	Fiscal cost (% del GDP)	Loss of output (% of GDP)	
			Lower limit	Upper limit
Finland	1991-93	11	22	45
Japan	1992-98	8	24	72
Norway	1988-92	8	10	27
Sweden	1991	4	3	12
Korea	1997	34	13	17
Argentina	1980-82	55	21	26
Chile	1981-83	41	24	41
Indonesia	1997	50-55	20	25
Mexico	1994-95	20	5	12
Thailand	1997	42	26	28

Source: Hoggarth, Reis and Saporta (2001), "Cost of banking system instability: some empirical evidence", Working Paper, Bank of England, Harvard University.