



CHILE

FINANCIAL SECTOR ASSESSMENT PROGRAM

TECHNICAL NOTE ON SYSTEMIC LIQUIDITY

September 2022

This Technical Note on Systemic Liquidity was prepared by a staff team of the International Monetary Fund in the context of the Financial Sector Assessment Program in Chile. It is based on the information available at the time it was completed on August 24, 2022.

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TECHNICAL NOTE

SYSTEMIC LIQUIDITY

Prepared By
**Monetary and Capital Markets
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program that held virtual meetings with authorities in Chile in March/April 2021. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

BCCh	Banco Central de Chile (Central Bank of Chile)
BCP	Central Bank Bonds denominated in Chilean pesos
BCU	Central Bank Bonds denominated in UFs
CMF	Comision para el Mercado Financiero (Financial Markets Commission)
CCP	Central Counterparty
CCVP	Special cash purchase / forward sale program
CEF	Consejo de Estabilidad Financiera (Financial Stability Council)
CLP	Chilean Peso
CSD	Central Securities Depository
DCV	Depósito Central de Valores (Central Securities Depository)
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
FCIC	Conditional Financing Facility for Increased Loans
FOGAPE	Fondo de Garantía para el Pequeño Empresario (Small Business Guarantee Fund)
FPD	Standing Deposit Facility
FPL	Standing Lending Facility
FSAP	Financial Stability Assessment Program
IMF	International Monetary Fund
ICSD	International Central Securities Depository
LOLR	Lender of Last Resort
MOU	Memorandum of Understanding
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
MPR	Monetary Policy Rate
NDF	Non-Deliverable Forward
PDBC	Central Bank of Chile notes
SOMA	Open Market Operations System
SP	Superintendency of Pensions
TA	Technical Assistance
UF	Unidad de Fomento, an inflation-indexed unit of account
USD	United States Dollar

EXECUTIVE SUMMARY

Chile is characterized by a highly interconnected financial system, which presents risks and opportunities for the development of liquidity markets. On the one hand, the large domestic non-bank financial sector (pension funds, mutual funds, insurers) creates a large investor base for domestic debt securities, fostering the development of these markets. On the other hand, the non-bank financial sector is vulnerable to shocks which may have significant spillovers to funding markets and to the banking system.

While the interbank money market is active, it is incomplete and sensitive to systemic liquidity shocks, given the absence of a secured money market. Because the interbank money market operates only on an unsecured basis, it is very vulnerable to confidence shocks. As a result, the trigger threshold for central bank system-wide interventions is rather low. While active domestic debt markets offer opportunities for the development of a secured interbank market, incentives for private initiatives towards that goal appear insufficient, as banks can rely on the central bank to address liquidity shocks.

In the context of the social turmoil in 2019 and the COVID-19 pandemic in 2020–2021, the Banco Central de Chile (BCCh) has introduced effective liquidity measures, though at the cost of excessive risk-taking. Unconventional measures to mitigate liquidity risks and to reduce banks' funding costs include targeted long-term refinancing operations, a significant expansion of eligible collateral (to bank bonds, corporate bonds, and credit claims), cash purchases/forward sales of bank instruments from non-bank financial institutions, foreign exchange swaps, and relaxations of regulatory liquidity requirements. While those measures have been largely effective in dealing with these two extraordinary macroeconomic shocks, they have caused a massive increase in the central bank's balance sheet and an excessive risk-taking.

Beyond the pandemic, the BCCh will need a more conservative collateral framework. While a return to the very narrow pre-crisis collateral framework would not seem justified, the BCCh's future steady-state collateral framework should incorporate more prudent haircuts and other risk control measures. Risk equivalence should be the guiding principle for the calibration of risk control measures, which should lead to a greater differentiation across eligible assets based on the identified risks. Haircuts should be conservative enough to protect the central bank against losses from liquidation of assets following a counterparty default. The acceptance of bank bonds as collateral should be limited to crisis times, with strict limits. A move from the current earmarking system to a pooling system, which would require some legal adjustments, would simplify collateral management.

An effective Emergency Liquidity Assistance (ELA) framework would help the BCCh to use its system-wide liquidity measures more parsimoniously. The ELA framework will address residual idiosyncratic liquidity stressed situations, thereby facilitating the gradual unwinding from system-wide unconventional measures.

The finalization and implementation of the ELA framework will require a close cooperation between the central bank and the banking supervisor. That cooperation should be formalized in a Memorandum of Understanding between the BCCh and the Financial Markets Commission (CMF). Significant technical work will be required to operationalize the ELA framework, including the preparation of an ELA Regulation, ELA internal procedures, an ELA Master Agreement and a funding plan template.

Table 1. Chile: Table of Recommendations

Recommendations	Authority	Timeline*
Interbank repo market		
Set up a working group with market participants on the development of the interbank repo market, and consider expanding the discussion with non-bank financial institutions	BCCh/CMF	Near-term
Define a strategy for repo market development, including improving infrastructures and setting appropriate incentives	BCCh/CMF	Medium-term
Organize interbank repo tests in real conditions	BCCh/CMF	Medium-term
Collateral framework		
Define a more conservative haircut schedule, based on risk equivalence	BCCh	Near-term
Define additional risk control measures for bank bonds collateral	BCCh	Near-term
Define a steady-state collateral framework, with eligibility extended to all marketable assets meeting minimum credit requirements, and excluding bank bonds	BCCh	Near-term
Reflect the recommendation against holding bank bonds in purchase program implementation and begin unwinding the current holdings	BCCh	Medium-term
Move from collateral earmarking to pooling	BCCh/MoF	Medium-term
Publish the revised collateral framework	BCCh	Medium-term
Regularly assess eligible collateral encumbrance and availability	BCCh	Medium-term
Reinforce the role of the risk management function in the design and implementation of monetary policy measures	BCCh	Medium-term
Emergency Liquidity Assistance		
Prepare an ELA Regulation, including all requirements for access to ELA, the ELA interest rate, and the maximum maturity of an ELA loans (2 weeks)	BCCh	Near-term
Prepare ELA procedures, including a priority order and risk control measures for ELA collateral	BCCh/CMF	Near-term
Finalize the MoU between the central bank and the banking supervisor	BCCh/CMF	Near-term
Prepare an MoU between the central bank and the Ministry of Finance	BCCh/MoF	Medium-term
Prepare an ELA Master Agreement	BCCh/CMF	Near-term
Prepare a funding plan template	BCCh/CMF	Near-term
Operationalize the solvency and viability assessments	CMF	Near-term
Prepare for ELA accountability and communication	BCCh/CMF	Near-term
Prepare for ELA through simulations	BCCh/CMF	Near-term
* Near-term: within 12 months; Medium-term: within 1 to 2 years.		