



CHILE

**REVIEW OF THE FINANCIAL
SYSTEM**

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FOREWORD

This review of Chile by the Committee on Financial Markets (CMF) was prepared as part of the process of Chile's accession to OECD membership.

The OECD Council decided to open accession discussions with Chile on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Chile to become a Member of the Organisation on 15 December 2009. After completion of its internal procedures, Chile became an OECD Member on 7 May 2010.

The CMF was requested to review Chile's financial system, including its market and regulatory structure, to assess whether it is market-oriented and sufficiently open, efficient and sound, based on high standards of transparency, confidence and integrity, for Chile to be able to accept the requirements of membership in the area of financial markets. The present report was finalised on the basis of information available in September 2009. It is released on the responsibility of the Secretary General of the OECD.

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LIST OF ABBREVIATIONS

AAFM	Association of Fund Managers
ADR	American Depositary Receipt
AFP	Pension Fund Manager
APV	Voluntary Pension Savings Plan
APVC	Collective Voluntary Pension Savings Plan
ASSAL	Association of Latin American Insurance Regulators
BCS	Bolsa de Comercio de Santiago (Santiago Stock Exchange)
CCP	Central Counterparty
CD	Certificate of Deposit
CDS	Central Securities Depository
CLCIO	Code of Liberalisation of Current Invisible Operations
CLCM	Code of Liberalisation of Capital Movements
COL	Constitutional Organic Law of the Central Bank
CORFO	Chile Development Promotion Agency
COSRA	Council of Securities Regulators of the Americas
CPI	Consumer Price Index
DIPRES	Treasury Budget Directorate
DNS	Deferred Net Settlement
DVP	Delivery versus Payment
ETF	Exchange-traded Fund
FEES	Economic and Social Stabilisation Fund

FEM	Formal Exchange Market
FICE	Funds Capital Investment Abroad
FICER	Investment Funds Risk of Foreign Capital
FOGAPE	Guarantee Fund for Small Enterprises
FRP	Pension Reserve Fund
HVPCH	High Value Payment Clearing House
HVPS	High Value Payment System
IFRS	International Financial Reporting Standards
IGPA	General Stock Price Index
IPO	Initial Public Offer
IPSA	Selective Stock Price Index
MAT	Marine, Aviation and Transport
NDF	Non-deliverable Forward
OPA	Public Stock Offer
OTC	Over-the-counter
SBIF	Superintendence of Banks and Financial Institutions
SD	Securities Depository
SP	Superintendence of Pensions
SVS	Superintendence of Securities and Insurance
TPM	Tasa de Política Monetaria (Monetary Policy Rate)
UF	Unidad de Fomento (inflation-linked currency unit)

I. INTRODUCTION AND OVERVIEW

A. Macroeconomic Context

The Chilean economy is starting to be affected by the economic slowdown across the world. While GDP growth has been around 4-5 percent over the last 3 years and the government still expects economic growth in the range of +0.25 and -0.75 percent in 2009, the numbers for the start of 2009 are not encouraging. According to the Central Bank of Chile, GDP declined by 2.3 percent year-on-year in the first quarter of 2009, and by 4.5 percent in the second quarter.

Inflation, which had run at levels of 4.4 percent in 2007 and 8.7 percent in 2008, has come down rapidly, and prices have actually declined since December 2008. The bout of inflation over the last few years has dimmed the central bank's prospects for moving the economy towards nominalisation. While the abrupt slide into a deflationary environment has also started to affect the profitability of the banking system, whose assets are almost fully inflation-indexed, the banking system remains profitable.

Past current account surpluses have disappeared as copper prices, while as of July 2009 still above long-term prices, have retreated from high levels. Yields on Central Bank bonds have fallen significantly. Chile's sovereign spreads have also increased, but less than in other emerging markets. Stock market capitalisation fell by about 20 percent in 2008, much less than in other emerging economies.

The government has reacted to the slowdown with a stimulus package worth about 2 percent of GDP, which was made possible by the surpluses accumulated in the Economic and Social Stabilisation Fund during the recent period of high commodity prices. In the light of sharply reduced inflation prospects, the Board of the Central Bank of Chile reduced the monetary policy interest rate to 0.5 percent. The Central Bank also announced, in its statement of 9 July 2009, that the monetary policy rate will be held at this minimum level for a prolonged period of time. To reinforce this decision and align financial asset prices with the path of monetary policy, the Central Bank further decided to implement the following complementary monetary policy measures:

- To establish a term liquidity facility (Facilidad de Liquidez a Plazo, FLAP) for banking institutions, whereby it will grant 90- and 180-day liquidity at the prevailing level of the monetary policy rate.
- To adjust the program of Central Bank note issuance at maturities below one year, in consistency with the aforesaid decision.
- To suspend, for the rest of 2009, the issuance of debt instruments maturing in or after one year, corresponding to two-year Central Bank peso-denominated bonds (BCP-2) and one-year Central Bank notes (PDBC-360).

B. Recent Trends in Financial Markets

Whereas Chile did not suffer much from the direct impact of the global financial crisis, as there was little exposure to “toxic” financial products, the country has not been completely immune to the global financial turmoil. Chilean institutional investors, especially those investing in international markets, incurred significant declines in the values of their portfolios. While recent indicators show that the economy may be turning around, some of the feedback effects of the economic slowdown on the financial system may yet continue.

Local liquidity in USD came under stress in September and October of 2008. The Central Bank concluded that this was caused by a fear of a sudden stop in external financing in the banking and corporate sectors, leading to liquidity hoarding. In response, the Central Bank and the Government announced a set of policies to provide liquidity to the financial system, and according to the authorities, these measures helped the market to return to more or less normal conditions by the end of 2008. The authorities do not believe that Chile is facing a potential funding gap.

Adjustment to the world financial crisis has focused on the exchange rate which initially depreciated about 25% in nominal terms starting in early September 2008, but has since come back to levels only about 7 percent lower than in September 2008. The authorities consider that some of the foreign exchange market volatility was caused by pension funds reducing their hedging positions, as significant mark-to-market losses on their foreign investments had left pension funds over-hedged against appreciation of the Chilean peso.

C. Summary

Over the past 30 years, Chile’s financial system has undergone significant development, with an increase in the number of participants, the variety of products, and market depth. Chile’s financial system is now well-developed by emerging market standards, and even by the standards of many OECD members. This applies in particular with regard to the long maturities available in the fixed-income market, which has benefited from the development of the mandatory private pensions scheme.

Whereas Chile implemented several capital market reform packages over the last few years in order to modernise and internationalise its capital markets, these have so far met with only limited success. A third reform package initially proposed by the government in 2008 has recently been re-launched by the government, which hopes to have it adopted during its current term of office. Chile’s financial sector is compartmentalised, meaning that banks for example cannot do equities business or own insurance companies, although all activities can be done by separate companies under a common holding structure. Most financial institutions indeed form parts of conglomerates.

In Chile, financial services are regulated and supervised by different institutions according to the type of financial service. The Superintendence of Banks and Financial Institutions (SBIF) and the Chilean Central Bank are in charge of banking, the Superintendence of Securities and Insurance (SVS) is in charge of securities and insurance, and the Superintendence of Pensions (SP) supervises the pension system and unemployment insurance. The institutional arrangements regarding the resources and independence of some of the Superintendencies have been questioned in the past, although some authorities have recently been strengthened in certain areas. Chile applies strong banking secrecy provisions, but reforms are underway to allow international exchange of bank information for tax purposes.

The Central Bank enjoys a special independent status under the Bank’s Constitutional Organic Law. Besides being in charge of monetary policy, the Central Bank is also in charge of a number of

specific regulatory tasks with regard to the banking sector, working together with the SBIF. Although most capital controls were abolished many years ago, the Central Bank still oversees the foreign exchange regulations and retains the power to impose capital controls.

Foreign presence through direct investment in the financial sector is substantial, with foreign players operating mainly through subsidiaries. Whereas foreign participation in the equity market has risen somewhat from low levels, foreigners remain absent from the local fixed-income market. In the foreign exchange market, Chile requires transactions to go through the Formal Exchange Market (FEM), and forward transactions are mainly done through non-deliverable forwards (NDFs)

The Chilean fixed-income market is unusual in that almost 90 percent of the market is inflation-indexed, almost always to the Unidad de Fomento (UF). There is no significant fixed-income market in Chilean peso. Primarily as a result of inflation-indexing, local fixed-income instruments have yielded strong returns, reducing the relative attractiveness of equities. Stock exchange turnover is comparatively low, reflecting the predominance of buy-and-hold investors and the low float associated with conglomeration.

The direct impact of the global financial crisis on Chile has so far been muted, due in large part to conservative regulation that hails back to the banking crisis in the 1980s, and to a still relatively low level of integration with international financial markets. The economic slowdown is, however, starting to affect Chile, and could have repercussions for lenders, particularly in areas such as retail lending and credit cards, sectors that had experienced strong growth over the last few years.

II. CHILE'S FINANCIAL SYSTEM IN A LONG-TERM PERSPECTIVE

Over the past 30 years, Chile's financial system has undergone significant development, with an increase in the number of participants, the variety of products, and market depth. Several events have been crucial in this process, like the liberalisation of interest rates in the second half of the 1970s, pension system reform in 1980, new laws governing the securities market and openly-traded corporations in 1981, the 1984 tax reform, the new Banking Law of 1986 and its subsequent modifications, the privatisation with non-concentrated ownership of the country's major public utility companies and banks, starting from the second half of the same decade, the positive impact that the return to democracy had on the international financial community, and the establishment of an autonomous Central Bank in the 1990s.

In 1981, as part of a fundamental pension reform, the pay-as-you-go pension system was replaced with a new Individual Capitalisation System. Over time, investment regulations for pension funds have gradually been liberalised. At the beginning funds were only allowed to invest in fixed-income instruments. In 1985, investment in equity of certain types of firms was authorised up to 30% of the fund. In 1989 and 1990 there was further liberalisation and investment in all types of publicly traded shares was authorised as well as investment in mutual funds and foreign fixed-income instruments.

The subsequent processes in the 1990s were focused on financial deregulation and market aperture toward a more sophisticated array of actors and products. It was a period with a specific objective to lift several existing restrictions in the local financial market, first by allowing domestic firms to raise capital abroad by issuing ADRs in international stock exchanges, and second, by relaxing the investment limits abroad for pension funds and insurance companies. In 1999, de facto capital controls in Chile were removed, shifting from a system of exchange rate bands to a floating exchange rate system.

The OPA (public stock offer) Law, passed at the end of 2000, was another major advance in this reform process. As in other Latin American countries, agency problems between owner and administrator have been addressed through a comptroller, who, given the high net worth involved, assumes the cost of monitoring. Although having a comptroller addresses the problem of monitoring, it does create risks that the minority shareholders will be expropriated. The OPA Law was designed to protect the rights of minority shareholders, penalising in a more precise manner the use of insider information and other abnormal financial practices.

The OPA Law was followed by the first capital markets reform (MKI) in 2001, a principal component of which was the abolition of capital gains tax for shares with a presence in the stock market. This reform vitalised the local stock market, in terms of both stock market capitalisation and volume traded. MKI also relaxed the investment limits for insurance company portfolios and created general fund managers.

In 2002, the limits on voluntary contributions to pension funds (AFPs) concerning Voluntary Pension Savings Plans (APVs) were lifted, and tax benefits were extended to the latter. That same year, the AFPs began to administer the multi-fund system. Each Administrator must offer five different types of funds, known as A, B, C, D and E Funds, which vary in their exposure to variable-income assets. The percentage of variable-income assets that these funds may contain ranges from 0-5

percent for E Funds to 40-80 percent for A Funds. In these cases, the minimum investment limits are defined in order to differentiate the five types of funds. The pension system has helped the development of new instruments and made it possible for new issuers to emerge.

In June of 2007, after a long period of discussion in Congress, the Second Capital Market Reform (MKII) entered into force. This reform was structured around three essential objectives: first, to foment the development of the risk capital industry; second, to enhance the safety of the securities market; and third, in general terms to promote the development of the financial market.

In terms of fomenting the risk capital industry, MKII established a tax exemption for capital gains obtained from the sale of shares of risk capital corporations, thus benefiting all entrepreneurs and angel and seed investors willing to buy into this type of corporation, and also all investors interested in investing risk capital through investment funds. As part of this objective, the reform authorised the development promotion agency (CORFO) to invest in quotas of risk capital investment funds and authorised banks, through their affiliates, to invest up to 1% of their assets in this type of fund.

Additionally, with the objective of facilitating more, and less costly, ways of organising capital contributions, and encouraging support for or control of management between investors and the owners of companies in which investments are made, MKII allowed for the creation of so-called share corporations. This new corporate structure has the flexibility typical of limited liability corporations, but under a capital structure similar to that of a closed corporation. Likewise, among other measures, the reform extended the life of tax benefits given to the Emerging Stock Market for an additional 8 years, created a new legal regime for the registered lien, and granted legal recognition to the subordination clause among non-preferred creditors.

For its part, in terms of the objective of promoting better security standards for the financial market, MKII established greater demands for custodianship of titles, created the obligation of accrediting sufficient knowledge for the main executives and employees of stock brokers, and strengthened the inspection authority of the Superintendence of Securities and Insurance (SVS) for cases in which institutions under its supervision demonstrate insolvency or financial weakness. Along this same line, and following international recommendations and good practices, MKII bestowed legal protection upon the Superintendents of Banks, Pensions, and Securities and Insurance, when faced with lawsuits originating from acts or omissions occurring while exercising their duty. This protection is extended even beyond the cessation of their duties. Likewise, MKII expanded the universe of instruments eligible for being guarded in the Central Securities Depository, legally established the principle of immunity of assets from seizure of securities in custody for debts held by a brokerage, and established for the latter the obligation to maintain securities held on their own behalf in accounts segregated from those held for third parties.

In terms of financial market development, the reform enabled the SVS to authorise the issuance of insurance policies in pesos (not necessarily indexed, as they are today) and expanded the array of investments representative of technical reserves and net worth for insurance companies. Perhaps one of the most emblematic measures approved by MKII has to do with the demutualisation of stock markets, which is the authorisation that enables stock markets to independently structure themselves among owners and stock brokers, thus eliminating the obstacles to the incorporation of new actors in the business of financial intermediation, and also establishing an incentive for innovation, integration, and development of the stock market.

Finally, this reform introduced a series of modifications to the legal statute that regulates the placement of foreign securities in Chile or the off-shore stock market, relaxing the requirements and conditions for registering and later publicly offering these securities and allowing them to be

registered not only by their issuers but also backed by brokers, securities agents, or even by the stock exchange.

In October 2008, Congress adopted a significant reform to the pension system (Law No. 20,255) which includes changes in the way investments are regulated. The reform includes modifications, including those listed below: a) The limit to AFP investment abroad is increased. It is currently 50 percent of the assets under management, and could increase up to 80 percent with the new regulation, b) Investment limits are relaxed; c) A Technical Investment Council is created, whose function is to approve financial regulations for Pension Funds, and particularly investment limits; d) New investment alternatives are authorised, incorporating derivative investment instruments. The Superintendence of Pensions is working, with the support of external consultants, on a methodology to be used in the implementation of the risk-based approach to supervision.

Law N° 20255 also introduced a new type of retirement's safeties, in which the employee and the employer participates (like U.S. 401k). This product can be offered in the securities market by fund managers through their funds and the other entities authorised by the SVS.

Likewise, this law incorporated the obligation for the Boards of Managers to establish investment and conflict-of-interest solution policies for each of the funds they administer, including the creation of an Investment and Conflict of Interest Solution Committee, comprised of three board members, two of whom must be autonomous (which basically means independent from the comptroller.) It was through this structure that managers were expected to formalise their investment policies so that their affiliates could become familiar with them, and so that an approach based on risk management could begin to be used.

A recent innovation in the legal framework is the recognition of (off-balance sheet) netting. The new legislation is designed to ensure that netting arrangements can be legally enforced, thus contributing to a reduction of risk in the financial system. There have so far not been any court judgments on the basis of this legislation, but the authorities are confident that claims arising from netting agreements will be enforceable in court.

Despite the comparatively advanced state of Chile's financial system, especially if compared to other countries in the region, some vestiges of a more controlled financial environment remain. One of these is the continued existence of various Central Bank surveillance mechanisms over the foreign exchange market. The other is the important role that indexation plays in the Chilean economy, and thus in its financial system. Almost all financial instruments are indexed to inflation and thus quoted in UFs (Unidades de Fomento) rather than in pesos. As institutional investors have most of their liabilities in UFs, they invest, as a matter of practice or indeed a matter of law (matching requirements) primarily in instruments that are linked to UFs. As foreign securities are not normally linked to UFs, these would have to be swapped back into UFs.

III. FINANCIAL INFRASTRUCTURE

A. Central Bank and Monetary Policy Framework

The Central Bank of Chile is a public law institution enshrined in the Constitutional Act of the Republic of Chile (Constitution of Chile), autonomous and of a technical nature. The Constitution of Chile expressly provides the autonomous character to the Central Bank. Likewise, the Constitutional Act defines the Central Bank as a body with its own equity, of a technical nature, whose composition, organisation, functions and attributes are determined through a constitutional organic law of its own.

Furthermore, pursuant to Section 109 of the Chilean Constitution, the Central Bank is only authorised to carry out operations with public and private financial bodies. The Central Bank cannot guarantee or acquire securities issued by the Government, its bodies or companies. Nor can it adopt agreements that involve discrimination or the establishment of rules and requirements that differentiate among persons, institutions or bodies carrying out operations of the same nature. Nor can it directly or indirectly finance any public expenditure or loan, except in the case of external war or danger thereof, which must be qualified so by the National Security Council.

In the context of the world financial crisis, the Central Bank has, however, decided to accept government securities as collateral. If such collateral has to be liquidated, and the Central Bank would effectively 'acquire' such securities, it would have to sell them immediately. At the same time, the Central Bank views such a situation as unlikely, as supervisors would likely intervene before a default requiring liquidation of collateral would occur.

Essentially, along with confirming the Bank's independence in technical and financial (equity) terms, the law also defines the objectives to be pursued by this institution: to ensure currency stability and the normal operation of domestic and foreign payments. To achieve these objectives, a suitable macroeconomic balance must be maintained within the formulation of all policies to be projected in time.

With regard to the technical nature of the Central Bank of Chile's autonomy, this stipulation refers essentially to its ability to establish its own agreements and make its own technical decisions in exercising its authority. Similarly, from the point of view of equity, the Central Bank of Chile is also autonomous, since the law granted it its own equity, which can be managed completely independently of the executive branch.

As a result of the autonomy granted by law, the Central Bank of Chile is not subject to supervision by the General Comptroller of the Republic or the Superintendence of Banks and Financial Institutions. Nor does it form part of the Government administration; instead, it is governed exclusively by its own rules, included in the Constitution of Chile and its Constitutional Organic Law, and enjoys sole authority for the administrative interpretation of its decisions, regulations, orders or instructions, notwithstanding the legal authority of judicial bodies and the Congress.

The Central Bank of Chile is governed by a Board, which is responsible for directing and managing the Bank, and exercising the authority and performing the duties entrusted to the Bank by law.

The Board is composed of five members appointed by the President of Chile, with the prior approval of the Senate. These appointments last for ten years; members can be reappointed for another period of equal duration, and positions are renewed every two years. The Governor of the Board and the Bank is appointed by the President of Chile from among the Board members for a period of five years, or for the period remaining in her or his term as board member. The Board itself elects the Vice-governor from among its members and this person remains in this position for as long as her/his appointment to the Board lasts. Both Governor and Vice-governor may be re-elected.

The Board can only function with the presence of at least three of its members and its motions must be approved by a majority of those present. In case of a tie, the Governor of the Board has the deciding vote. The position of Board member requires exclusive dedication and is not compatible with any other activity, remunerated or otherwise, in the private or public sectors, except for teaching or academic activities.

Board members can be removed through accusation to the Court of Appeals of Santiago, based on the argument that the respective board member has intervened or voted on resolutions that influence credit operations, investments or other business in which he/she or his/her spouse, or relatives to the third or second degree once removed, have a proprietary interest; or in which the board member has been involved in conducts that involve an abuse of his/her quality as such in order to obtain for her/himself or third parties, direct or indirect benefits.

Similarly, the President of Chile, with prior approval of the Senate, can remove a board member who holds the position of Governor of the Board and Bank, upon receiving a well-founded petition from at least three members of the Senate, for reasons of incompliance with the policies adopted or the rules applied by the Board. Finally, the President of the Republic, also with prior approval of the Senate, is empowered to remove any or all board members, based on a situation where the board member in question has voted for Bank motions that imply a grave and obvious incompliance with its objectives and provided that this motion has been the main and direct cause of serious damage to the country's economy.

The Central Bank implements its monetary policy by defining a target level for the nominal interbank interest rate, which is known as the monetary policy rate (*tasa de política monetaria*, TPM). To ensure that the interbank rate falls within the target range, the Central Bank regulates financial system liquidity (or reserves), through the use of several instruments: open market operations, buying and selling short-term promissory notes and liquidity deposits, and lines of credits (expanded facilities). These tools also include the banking reserve over deposits, although in current practice the Central Bank does not use this as an active monetary policy instrument.

The explicit objective of the Central Bank of Chile is to maintain annual inflation of the consumer price index (CPI) at around 3% most of the time, with a tolerance range of plus or minus one percentage point. This objective should be permanently achieved in a medium-term horizon of two years. The Central Bank is concerned not only with scenarios in which inflation exceeds the target in the relevant horizon, but also with scenarios in which it falls too low. The Central Bank of Chile does not aim for an inflation level below the specified range because of the risk of deflation. Moreover, the Central Bank considers that the horizon is consistent with the time period over which monetary policy achieves its maximum effect and is therefore the period during which monetary policy can exercise the greatest control over inflation.

Section 36 of the Constitutional Organic Law of the Central Bank of Chile in connection with the General Banking Act provide for the Central Bank to act as a lender of last resort to financial institutions facing temporary liquidity shocks.

Open market operations are carried out by the Central Bank of Chile pursuant to Section 34 of its Constitutional Organic Law. Such operations take place essentially through regular auctions of securities issued by the Central Bank. Banks, pension fund managers, insurance companies and mutual funds can participate in these auctions. Securities auctions take place in the form of a single price per auction, which is the cut-off rate applied to all the winning participants in the auction (“Dutch type”). The approach encourages competition among auction participants and tends to reflect more appropriately the conditions prevailing in the market place. In the event of deviations from the (average) interbank rate from the desired policy rate, for example because of a lower level of liquidity than that required, liquidity is injected to reduce the interbank rate and make it converge toward the TPM. In general, liquidity is injected by purchasing securities using a repurchasing clause (REPO). In the opposite situation, when excess of liquidity is present and the interbank rate is tending to fall below the target rate, the temporary excess is withdrawn by selling short-term notes. These last operations take the form of “dematerialised” documents.

Other tools at the Central Bank’s disposal are the liquidity credit line and the liquidity deposit account. Using the first, under special circumstances the Central Bank provides financial institutions with one-day loans without collateral, for limited amounts and by interest rate tranche. Furthermore, since January 2009 the Central Bank has the possibility to employ a supplementary mechanism to provide liquidity for periods exceeding 28 days on the basis of a credit line with collateral that includes, among other securities, bonds issued by the Treasury and banking time deposits as eligible collateral. On the other hand, the liquidity deposit allows financial institutions to deposit, for one day, temporary liquidity surpluses in the Central Bank and obtain a minimum return.

To suitably regulate liquidity in the financial system, the Central Bank prepares a cash flow program that covers the period during which the reserve requirement is measured. To develop the cash flow plan, both the supply of and demand for banking reserves, that is bank notes and coins in the possession of banks and bank checking account balances in the Central Bank, are projected. Demand is of a derivative nature that basically depends on reserve rates and trends foreseen for demand and time deposits such as the behaviour of currency in the hands of the public. The supply of banking reserves depends on the behaviour of currency in the public’s hands and the main sources of emission, including the expiry dates for promissory notes auctioned off during previous periods and other sources of monetary expansion that are more autonomous and require their own projections. These operations include the Government’s financial operations with monetary impact.

Once the supply and demand for banking reserves has been determined, the amounts of promissory notes to be auctioned off by the Central Bank are decided. The auction calendar is provided to the public the day before a new reserve period begins. Daily follow-up of the liquidity projection is essential to ensure, wherever necessary, that the operations necessary to fine tune bank reserves take place, through the REPO operations mentioned above or special sales of short-term promissory notes.

The Central Bank continues to be under-capitalised, as a result mainly of the Central Bank’s sterilisation operations and its involvement in bank recapitalisation during the 1980s. This is why a part of the government budget surplus is dedicated, in accordance with the Fiscal Responsibility Law, to the recapitalisation of the Central Bank of Chile. At the end of 2008, the Central Bank’s net worth had improved to a level of 0.5 percent of GDP. The IMF, in its 2009 Article IV consultation,

recommended, however, that capitalisation of the central bank be raised further in light of projected revenue volatility and budget deficits.

B. Payments System

As per Section 3 of its Constitutional Organic Law, the Central Bank of Chile's objectives include ensuring the normal functioning of domestic payments. To do so, it enjoys a series of regulatory and supervisory powers over payment systems and also promotes standards of efficiency and security approaching those applied internationally and consistent with best practices in this field.

In Chile, two high-value payment systems (HVPS) operate: the Central Bank's Real-Time Gross Settlements (RTGS) system managed and run by the Bank and the high-value payment clearing house (Cámara de Compensación de Pagos de Alto Valor, HVPCH), managed and run by ComBanc S.A. which is a supporting company for the banks. The former started its operation in April of 2004 and the latter in December of 2005.

The RTGS system liquidates transfers of funds in pesos as per instructions from banks on their own initiative or on behalf of their customers, but always acting in their own name. It also transfers net results from clearing houses used by banks (checks, automatic tellers and high-value). All operations between the Central Bank and participants for which settlement requires debiting or crediting peso accounts held in the Central Bank are settled by this system.

Although settlement of high-value payments through the RTGS system eliminates settlement risk for these transactions, it can potentially create liquidity pressures among participants, so suitable measures for providing liquidity are also necessary. To meet this need, the Central Bank also developed an electronic platform for carrying out security purchasing operations with buyback clauses (repos). This intraday liquidity facility (ILF) is totally collateralised by the actual transfer of eligible securities to Central Bank position accounts in the securities depository, which are reversed on request or automatically by day's end.

Unlike the RTGS system, in which transfers are settled on a gross level, the HVPCH is a deferred net settlement (DNS) system, in which payments are offset in a multilateral fashion using risk control mechanisms based on bilateral and multilateral ceilings, along with a guarantee system that ensures final net settlement. Implementation of both HVP systems made it possible to implement delivery versus payment models (DVP) in settling securities, thereby reducing participants' risk and improving efficiency.

Regarding the stability of the payments system, during 2007, continuity plans were expanded to cover additional low probability/high impact scenarios. One line of work established an external contingency room that would provide services in the event of some barrier to accessing central facilities. Moreover, the Central Bank also took measures to reinforce operations (duplicate components) should some event affect the RTGS system, preventing normal recovery measures. Under these circumstances, one priority would be quick recovery of participants' balances just prior to failure and manual start-up. A tool was developed for this purpose, based on the SWIFT messaging system.

As part of modernising financial infrastructure, the Central Bank has met with industry representatives (Santiago Stock Exchange, ComBanc, Central Securities Deposit and the Association of Banks and Financial Institutions) to more closely examine financial infrastructure capacity in order to continue providing specific services in the event of another operator's failure. Similarly, it

coordinated efforts to evaluate suitable management of payment and settlement systems, in the event of an unusual surge in security or settlement transactions.

Credit card payments in Chile are processed by Transbank, which is jointly owned by the largest Chilean banks. Over the last few years, there has been a strong increase in the issuance of non-bank credit cards, which have reportedly surpassed bank issued credit cards in number.

IV. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: BANKING SYSTEM

Chile's banking system is largely privately owned (except for BancoEstado, see below), with a significant presence of foreign-owned subsidiaries (11 out of 20 banks). The largest players are Banco Santander (Spain), Banco de Chile (local), Banco del Estado (state-owned), Banco de Crédito e Inversiones (local), and Bilbao Vizcaya Argentaria (Spain). In addition to the local banks and the subsidiaries, four direct branches of foreign banks are registered in Chile: Banco de la Nación Argentina, Banco do Brasil, JP Morgan Chase Bank, and Bank of Tokyo-Mitsubishi UFJ. All of the branches primarily conduct corporate banking. Banking system assets were 116 percent of GDP at the end of December 2008.

The banking system has one bank that is 100 percent owned by the State: the State Bank of Chile (Banco del Estado de Chile, now called BancoEstado). BancoEstado had a market share of about 15 percent as of end-2008, giving it third place in the banking system. In small-scale lending, market participants estimate the market share of BancoEstado at about 70 percent. The bank recently received a USD 500 million capital injection from the Chilean government. BancoEstado is subject to the same regulation and supervision as other banking entities operating in Chile. It is, however, governed by its own law, the Organic Law of the Banco del Estado of Chile D.L. 2.079 of 1977, and, according to the law, may be granted advantages or exclusive rights.¹ BancoEstado is, however, not permitted to provide loans to state-owned institutions.

Table 1: Chile - Ownership Structure of the Five Largest Banks (end-2008)

Bank	Market Share	Main Shareholders	Ownership Share
Banco Santander	20.5 %	Santander (Spain)	majority
Banco de Chile	17.6 %	LQ INV Financieras S.A. (32.96% Citibank; 67.04% Quiñenco, owned 83% by Luksic group)	62 %
Banco del Estado	14.9 %	State of Chile	100 %
Banco de Crédito e Inversiones	13.1 %	Empresas Juan Yarur S.A.C.	53 %
Bilbao Vizcaya Argentaria	7.5 %	Bilbao Vizcaya (Spain)	majority
<i>Total</i>	<i>63.3 %</i>		

Source: SBIF. Data as of 31 December 2008. Market share based on total assets for each bank.

There have recently been an important number of mergers and acquisitions in the Chilean banking industry. In January 2008, a merger was completed between Banco de Chile, the country's second largest bank, and Citibank. The subscribed shareholders pact allowed Citibank to increase its share, which stood at 10 percent at the end of 2008, to 50 percent, but with control remaining with the Luksic group. This option has now been extended to 2010. Banco de Chile, which had to be bailed out in the previous banking crisis in the 1980s, continues to make repayments to the Central Bank in the form of dividends. In 2007, other important acquisitions took place. Local banks HNS and Banco del

¹ These include, but are not limited to the keeping of the government's unified fiscal account.

Desarrollo were bought by Rabobank and Scotiabank, respectively, and Banco Itaú bought out the Chilean operations of Bank of Boston.

Financial conglomerates

Chile operates a financial system based upon separation of activities, whereby banks are not permitted to directly engage in other activities such as insurance or investment banking and vice versa. Banks therefore typically operate as part of larger conglomerates, where the bank itself is controlled by a holding company, which also controls a host of other group companies, which may include securities firms, insurance companies, and/or fund and pension managers. The bank itself can, however, own a brokerage company, which in turn cross-sells the products of the other group companies. In many cases, it appears that the separation of the various activities is more of a formal than a functional nature.

In some cases the legislation directly allows for some complementary activities or delegates authority to the respective superintendence to authorise other activities. For example, banks can establish, i) affiliate firms and ii) firms that are complementary to a bank's line of business. In the first case, through affiliate firms, banks are allowed to carry out securities brokerage, establish mutual fund managers, investment fund managers, or securitisation firms. The second case means that banks are allowed to establish firms in order to facilitate the fulfilment of the objectives of financial entities. One example would be the firms through which banking firms administrate their ATM services or hold a share of securities depositories (SD). The following table presents information as of March 2008 about affiliate firms and firms that complement the line of business carried out by banking entities.

Table 2: Chile – Banking Affiliates (March 2008)

Affiliate firms	Number	Assets (in millions of pesos)
Mutual Fund Admin.	2	36,035
Securities Agents	4	902,298
Financial Advising	10	22,276
Leasing Companies	2	68,533
Stock Brokers	11	5,753,525
Real Estate Leasing	2	85,507
Collection Firms	4	17,550
Insurance Brokers	11	113,276
Securitising Firms	3	14,004
Factoring Firms	4	574,746
General Fund Admin.	11	177,935
Total affiliates	64	7,765,690
Firms that complement the bank's line of business	21	444,732

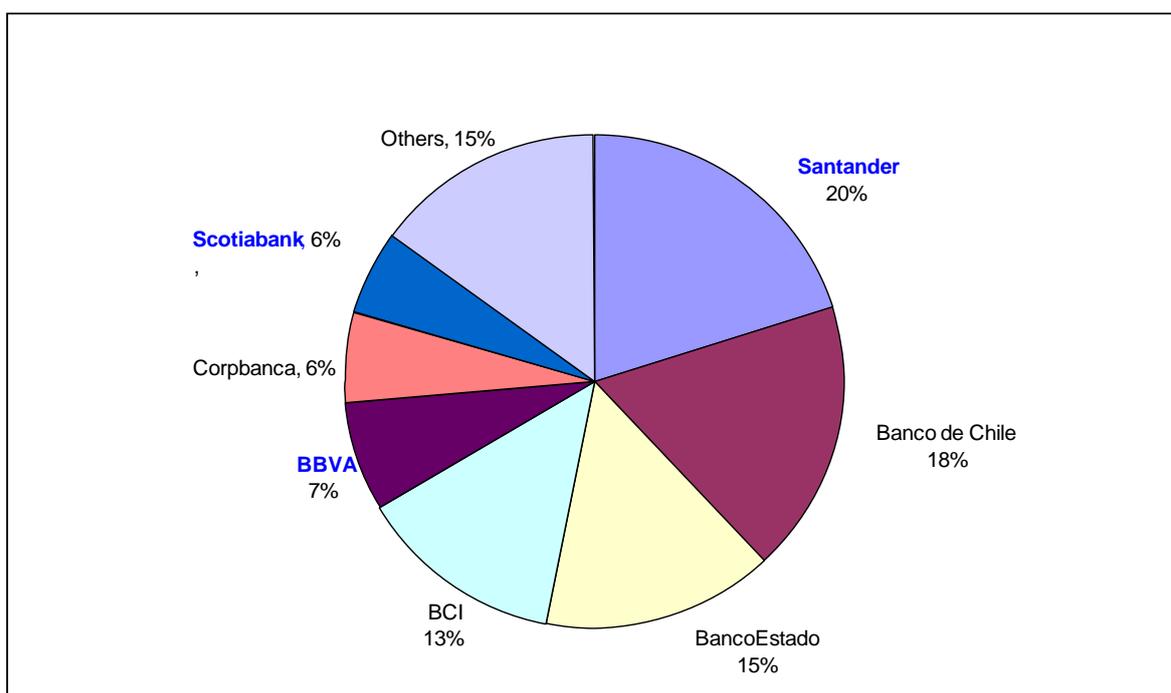
Source: SVS

As of November 2008, the SVS had identified eleven groups controlled by commercial banks. In terms of corporate groups, there are 18 groups that participate in the banking industry and 17 groups that participate in the insurance industry. Article 96 of the Securities Market Law defines a corporate group as a group of entities that have linkages in their ownership, management or credit responsibility, leading to the presumption that the economic and financial performance of its members is guided by the common interests of the group or subordinated to it, or that there are financial common risks in the credits granted to them or in the acquisition of securities they issue. Whereas the SVS has information about holdings that own companies under SVS surveillance, the SVS does not have much information about non-regulated companies. Whereas two groups have voluntarily provided information to the SVS, the process of collecting such information from others is still at the beginning.

Concentration of the banking system

The Chilean banking system shows a high degree of concentration, with the four largest banks in Chile accounting for over two-thirds of banking system assets at the end of 2008. The Herfindahl index stood at 1328 at the end of 2008. The distribution of the market shares among the larger players is, however, relatively even. Santander has the highest market share with about 21 percent, followed by Banco de Chile with 17.6 percent. BancoEstado has 14.9 percent, BCI 13.1 percent, and BBVA a 7.5 percent market share. The relatively even distribution of market shares may, in part, reflect the authorities' interest in not letting individual players grab very high shares in certain market segments. Regulatory incentives may implicitly limit, to some degree, the eagerness of larger players to engage in too much competition for sight deposits.²

Chart 1: Chile – Banking System Market Shares (November 2008)



Source: Central Bank of Chile

² According to market participants, one such incentive is the requirement that banks hold central bank securities against sight deposits in excess of 2.5 times their own funds.

Therefore, the main competition for banks has in recent years come from the side of the large retailers, who have taken over a large part of the credit card market, especially in the low-income segment, and expanded into a number of other financial activities, including through banking institutions that form part of these conglomerates.³ The Central Bank estimates that 30 percent of total household debt is outside the banking system. In some areas, banks also face competition from the larger securities firms. On a limited scale, insurers can also provide loans. Banks try to fend off the securities firms by limiting their direct access to derivatives, and the non-bank card issuers are keen to maintain their information advantage by sharing only negative credit histories with the banks. Bank credit histories are shared through the SBIF (positive histories) and the Santiago Chamber of Commerce (negative histories).

Soundness of the banking system

While the authorities are concerned about the effects that the global downturn will have on Chile, especially through lower demand for Chile's exports, Chile finds itself in a much stronger position than in the past to face the possible impacts. The authorities note that the system has in the past had the ability to adjust and perform satisfactorily through a long period of economic slowdown and regional instability. Stress tests done by the Central Bank show, according to the authorities, that the system is capable of facing the expected risks of even extreme scenarios. Nevertheless, the Central Bank, in its Financial Stability Report for the second half of 2008, suggested that Banks should increase their capitalisation.

The authorities consider that the firms for which the supervisors currently have information are in a healthy financial situation, as many firms took advantage of the favourable financial conditions of recent years to lower their debt burdens. The authorities also consider that derivatives in Chile are mainly used for hedging purposes, and that high-risk speculative contracts that have been observed in other countries are absent from the Chilean market. Similarly, the information available to the authorities indicates that there is no significant direct exposure of the Chilean financial institutions to financial institutions with difficulties, either as holders of assets or as counterparties in derivative contracts.

Chilean banks and enterprises have so far been able to retain access to foreign funding, although at higher spreads and shorter periods than in normal circumstances. Institutional investors have reportedly repatriated part of their external assets to Chile, and thus helped to ease the adjustment of the economy to the deterioration of the external environment. After undergoing significant stress in September 2008, it appears that by January 2009 the interbank market had returned to more or less normal market conditions, although compared to before the crisis, collateral requirements have increased and maturities shortened. Banks were in fact reporting excess liquidity as a result of shifts by investors from mutual funds into bank deposits, repatriation of assets from abroad, and the reassurance provided by the new central bank facilities. In the absence of attractive alternatives, the banks seem to have fallen back on investing in CDs issued by other banks.

Market participants expect consumer lending growth to come to a halt in 2009, down from an average pace of some 20-30 percent in the last few years, and in December and January lending actually contracted by 2 percent. The slowdown in lending is expected to entail rising non-performing loan ratios. Losses on retail lending are starting to edge up, and with unemployment rising, a shake-up in retail lending is to be expected. Nevertheless, with consumer and mortgage lending still at only 10

³ Chile is said to be the only country in the world where major retailers have more credit cards in circulation than banks. There are reportedly about four times more cards issued by retailers than by banks.

and 18 percent of GDP respectively the effects of emerging problems in retail lending may have less impact on the overall economy than in many OECD countries.

Several banks have started to report their preliminary 2008 results, and it appears that the results of some banks were affected by the downturn in the last quarter. In the case of Banco de Chile, for example, annual profits declined 35 percent year-on-year. Banco Santander reported a 10 percent increase in net income for the year, but also a 50 percent year-on-year rise in provisions, driven by higher charge-offs in consumer loans due to the economic slowdown, as well as an increase in provisions in the middle-market following negligible levels in the previous three years. The other banks are expected to feel the slowdowns as well, although so far it appears that the impact will be felt more fully in 2009. Numbers for January 2009 appear to confirm this, with loan loss provisions consuming, for most banks, between one-third and one-half of their monthly profit, and four banks reporting a loss for the month.

On the side of the (non-bank) credit card issuers, total credit card debt totalled USD 4.9 billion at the end of 2008, according to the Superintendence of Banks and Financial Institutions (SBIF). For all non-bank issuers, 15 percent of loans were classified as late by more than 30 days, although this ratio varies considerably among issuers, ranging from 8 percent or lower for some, up to almost 33 percent for others. Overall, the delinquency rate on non-bank credit cards did not change significantly during the year 2008, although it can be expected that the rate will edge up if Chile is affected more severely by the economic slowdown. The largest issuer of non-bank credit cards in Chile is Falabella, with about a 25 percent market share, followed by Dorada La Polar, Ripley, Más Paris, and Presto.

Box 1. Chile – Credit Bureaus

Credit supply in Chile comes from two important providers: banks as the main providers of corporate credit, and retailers that provide consumer credit through credit cards (casas comerciales). According to the SBIF, 67 percent of the banks' loan portfolio is devoted to commercial loans, and 33 percent to the individual segment (14 percent consumption loans and 21 percent mortgage loans). The consumer credit market has been very competitive, with competition taking place between banks and retail credit providers. The Central Bank's stability bulletin reports that 30 percent of the total household debts are outside the banking system. According to the SBIF bulletin, there are 29 million credit cards issued by retailers, of which 8 million are used monthly.

The credit reporting industry started to be developed early in the last century (1920s) through the Boletín de Información Comercial (BIC). In the late seventies, private credit registries started to operate. The SBIF operates the public credit registry (Sistema de Deudores, SD), which receives and disseminates information from regulated financial intermediaries. The SD is accessible only for banks.

There is a broad opinion that the current system should be improved; positive credit information from retailers and other lenders is not available; only banks share among them positive credit information; there is weak consumer protection (the sole alternative is to initiate a lawsuit before courts); and there is no regulatory and enforcement agency that oversees the system.

To improve the system, the government in September 2008 presented a bill to reform the legal framework. The proposal is to establish a Central Registry of Economic Liabilities (RECOE) that will be managed by a private concessionary, selected through an open bidding process. The bill makes it compulsory for relevant lenders to provide information on positive and negative debt (data on assets is NOT collected), and designates a regulatory agency for the information industry, and an autonomous agency for personal data protection. This registry would maintain the liability data for up to ten years since the date of debt clearance or default. The aim is to achieve higher data protection, consistency, and quality.

Credit bureaus would have to purchase the credit history from the RECOE at homogeneous prices or fees, and sell it to final purchasers (lenders, commercial retailers, individuals). They are free to complement this information with other data obtained from sources accessible to the public, such as the real state registry. To purchase data on positive debts, credit bureaus must present the consumer's consent before the RECOE. The credit bureau industry will be regulated and overseen by the Banking Regulatory Agency (SBIF).

Table 3: Chile – Capital Adequacy of the Banking System (June 2009)

Institutions	Indicators (%) (1)		Components (MM\$)						Share of own funds (%) (5)		
	Own funds Risk-weighted assets	Core capital Total assets	Own funds				Assets		Subordinated bonds Core capital	Voluntary provisions Risk-weighted assets (credit risk)	
			Core capital (2)	Assets deducted (3)	Voluntary provisions (4)	Subordinated bonds	Total own funds	total			risk-weighted (credit risk)
Banks incorporated in Chile	13.95	7.71	6,578,549	232,073	120,443	1,981,542	8,448,461	85,330,930	60,561,075	30.12	0.20
Banco Bice	12.92	6.90	196,767	1,050	7,340	63,518	266,575	2,853,363	2,063,194	32.28	0.36
Banco Bilbao Vizcaya Argentaria, Chile	12.90	5.97	460,179	79	16,137	213,261	689,498	7,705,574	5,344,116	46.34	0.30
Banco de Chile	13.57	7.62	1,343,992	3,787	44,938	419,908	1,805,052	17,646,057	13,296,920	31.24	0.34
Banco de Crédito e Inversiones	12.08	6.38	825,672	6,368	7,992	351,631	1,178,927	12,934,261	9,760,012	42.59	0.08
Banco Falabella	19.37	9.65	88,669	0	0	36,681	125,350	918,890	647,298	41.37	0.00
Banco Internacional	11.63	5.80	31,986	0	1,136	13,613	46,735	551,495	401,923	42.56	0.28
Banco Itaú Chile	14.54	9.25	295,568	0	791	34,442	330,801	3,196,005	2,275,727	11.65	0.03
Banco Monex	45.56	15.28	10,636	0	0	0	10,636	69,617	23,347	0.00	0.00
Banco Paris	12.66	10.48	23,998	0	0	0	23,998	229,071	189,542	0.00	0.00
Banco Penta	64.00	30.16	23,609	325	0	0	23,283	78,284	36,378	0.00	0.00
Banco Ripley	14.77	12.00	31,294	0	0	0	31,294	260,737	211,944	0.00	0.00
Banco Santander-Chile	15.08	7.30	1,497,019	0	9,928	535,978	2,042,925	20,506,101	13,544,319	35.80	0.07
Banco Security	12.15	5.81	188,160	0	436	91,512	280,109	3,240,526	2,305,036	48.64	0.02
Corpbanca	12.34	7.59	478,179	204	0	132,990	610,965	6,299,895	4,952,077	27.81	0.00
Deutsche Bank (Chile)	25.73	10.72	77,123	0	0	0	77,123	719,355	299,752	0.00	0.00
HSBC Bank (Chile)	23.05	9.66	93,598	0	0	0	93,598	969,225	406,094	0.00	0.00
Rabobank Chile	17.33	8.52	34,929	0	0	0	34,929	409,942	201,584	0.00	0.00
Scotiabank Sud Americano	14.96	12.58	744,859	220,260	31,747	88,006	644,352	5,919,015	4,306,802	11.82	0.74
The Royal Bank of Scotland (Chile)	44.85	16.07	132,313	0	0	0	132,313	823,515	295,011	0.00	0.00
Banco del Estado de Chile	10.94	4.89	778,198	0	13,000	323,682	1,114,879	15,919,083	10,190,928	41.59	0.13
Branches of foreign banks	178.33	45.49	370,612	0	365	0	370,977	814,703	208,032	0.00	0.18
Banco de la Nación Argentina	147.85	71.56	16,812	0	0	0	16,812	23,493	11,371	0.00	0.00
Banco do Brasil S.A.	77.47	62.96	22,287	0	365	0	22,652	35,400	29,238	0.00	1.25
DnB NOR Bank ASA	4,630.42	98.14	135,351	0	0	0	135,351	137,917	2,923	0.00	0.00
JP Morgan Chase Bank, N.A.	120.36	33.32	176,185	0	0	0	176,185	528,700	146,380	0.00	0.00
The Bank of Tokyo-Mitsubishi UFJ, Ltd.	110.25	22.40	19,978	0	0	0	19,978	89,193	18,120	0.00	0.00
Banking System	14.00	7.57	7,727,359	232,073	133,808	2,305,223	9,934,318	102,064,715	70,960,036	29.83	0.19
Banco del Desarrollo	12.34	5.96	172,566	751	28,900	86,283	286,997	2,894,297	2,326,543	50.00	1.24

Source: SBIF

V. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: CAPITAL MARKETS

A. Capital Market Intermediaries

Due to the mandatory separation of functions, certain activities in the Chilean financial markets cannot be carried out by banks directly, but are undertaken through broker-dealers, which may form part of the same group. This is particularly the case for equities, as banks are not normally allowed to own stocks. Broker-dealers therefore play an important role in the capital market. Whereas some brokers trade only on behalf of clients, others also engage in proprietary trading. The brokers up to now also act as custodians for client assets. Although clients have the authority to request assets to be held in the central securities depository, few of them do so owing to the higher cost involved.

Some brokers have expanded their business to a wide variety of investment-related services, including fund management and mergers and acquisitions. They can also now become primary dealers for government securities. These brokers act as de-facto investment banks, although officially this term does not exist in Chile. There are some areas, however, that the broker-dealers have not been able to enter on a significant scale. One is derivatives trading, as banks do not give brokers access to their derivatives trading platforms. The other is Formal Exchange Market (FEM), which is reserved for banks and other authorised agents, according to some market participants providing them with revenues to repay debts to the Central Bank.

B. Fixed-Income Market

The Chilean fixed-income market is peculiar in that almost 90 percent of the market is inflation-indexed, with even higher shares for corporate bonds (95 percent) and mortgage-backed securities (100 percent). Indexation is almost always to the Unidad de Fomento (UF), which is adjustable on a daily basis according to the previous month's consumer price inflation. There is no significant fixed-income market in Chilean peso. Pension funds and insurance companies account for more than three-quarters of market demand, and there is little participation from foreign investors in the Chilean fixed-income market. Local fixed-income instruments have yielded strong returns, primarily as a result of inflation-indexing.

Government debt

The main issuers in the Chilean sovereign debt market are the Central Bank, which covers the short end, and the Finance Ministry, which issues longer-term securities. Although the Central Bank has increasingly issued non-indexed securities, as part of its effort to move to nominalising at least the short end of the market, about 80 percent of government debt is still denominated in UFs.⁴ Government securities are issued on a monthly basis through a Dutch auction, where the issuer is not under obligation to accept if the price is considered inadequate. The list of primary dealers has been widened to include non-banks.

⁴ The government expects, however, that peso-denominated debt will represent approximately 25% of total Treasury issuances in 2009 (about US\$780 millions).

Chile currently has three Eurobonds outstanding. The Chilean government is planning to replace the first one, which matures in April 2009 by a new benchmark issue. The other two bonds mature in 2012 and 2013, respectively. The IMF had recommended that Chile consolidate sovereign paper into fewer benchmark issues, which is complicated by the varied objectives of maintaining both a nominal and inflation-indexed yield curve and providing long-duration assets for institutional investors.

In the case of public debt, the Finance Ministry is responsible for the Treasury's strategy of indebtedness, whose objective is to support the liquidity and depth of local financial markets, establishing reference interest rates in order for Chilean companies to access the capital market. In operative terms, the Finance Undersecretariat interacts in a co-ordinated manner with the Treasury, the Budget Directorate (DIPRES) and the Central Bank (Fiscal Agent that issues Treasury bonds).

For financial assets, the Finance Ministry decides upon and implements the investment strategy for fiscal resources, especially the strategy related to the Economic and Social Stabilisation Fund (FEES), the Pension Reserve Fund (FRP) and the new Bicentenary Human Capital Fund (Sovereign Funds). The Finance Undersecretariat works in close co-ordination with the Financial Committee, DIPRES and the Central Bank (in its role as Fiscal Agent), examining the performance of the investments of Sovereign Funds, monitoring the implementation of investment policies and participating actively in the worldwide debate on the best practices by which countries holding sovereign bonds must abide. Currently, all investments of Sovereign Funds are overseas, with 70 percent in sovereign bonds (2.4 years average maturity), and 30 percent in money markets.

Public Treasury surpluses, which are used to finance the budget or which act as a transition account to make transfers to Sovereign Funds, are invested on the short term both in Chile and abroad. For these resources, a formal mechanism was recently implemented for bidding on deposits, in which any bank in Chile's banking system can participate in the auction.

Corporate bonds

As companies begin financing new projects, they have found the capital market to be a good alternative source for financing. While this alternative was only used by a few companies in the 1990s, after the Asian crisis issuance of corporate debt expanded heavily. The growing use of the capital market was reflected in a rise of the ratio of debt to bank loans from approximately 6 percent in the 1990s to close to 13 percent at the end of 2007. Almost all corporate debt in Chile (95 percent) is indexed to UF.

There are particularities in Chile that give incentives to use the bond market. Whereas the tax system allows shareholders of companies that distribute a minimum of 30% of their profit as dividends, to avoid capital gains tax in exchange for a 17% tax on these dividends, Chilean companies still prefer to finance their projects through debt, or to reinvest profit, as an alternative to issuing equity. Most importantly perhaps, business conglomerates are a key feature of the corporate Chilean landscape that provides another source of internal funding by reassigning funds inside the group.

Furthermore, some institutional investors face restrictions on the risk level of the debt instruments they can acquire. These restrictions, which especially concern pension fund investments, have prevented the development of much of a high-yield bond market in Chile. With the change in the investment regime introduced in the 2008 pension reform, which allows AFPs to buy instruments with low risk ratings, the authorities had expected that AFPs would become more interested in debt instruments from riskier companies, although that is less likely in the current situation.

Last, Chile's stamp tax, which is a tax on the legal act of originating any kind of credit, means that it is more convenient to issue debt with longer periods of maturity, in order to amortise stamp tax expenses. The stamp tax, together with the investment strategies of pension funds and insurance companies, which must comply with rules governing the balance between assets and liabilities, has led to the creation of a debt market with very long terms to maturity. For example, as of July 2008, the stock of current bonds had a weighted maturity of approximately 18 years, which is much longer than the debt maturities seen in other countries. This is generally an advantage, but poses a dilemma for some, as it is not easily paid off by medium-size companies or those that have not been in business for a long time.

Rating agencies

There are four risk rating companies in Chile, three of which are affiliated with the large international rating agencies. For risk rating entities, the legislation establishes that at least 60% of the share capital should belong to the main partners. A main partner is understood as one who is the individual owner of at least 5 percent of the corporate governance rights. The sole purpose of the agencies is the credit rating process for securities, although the SVS may also authorise other activities. A credit risk rating for the public offering of bonds and bills is mandatory by Law.

In order to offer credit rating services, companies must be registered at the SVS. The application must contain information about the company and its partners, administrators and those responsible for management of a certain rating. The principal partners or administrators of a rating entity and the people who oversee management of a specific rating, must be professionals with five-year university degrees, or must hold equivalent higher education degrees; and they must have impeccable business backgrounds. All of the administrators and persons overseeing the management of a specific rating must also have work experience of at least three years in the economic-financial area.

In addition, they must provide a copy of the internal rule detailing the process for assigning rating categories. The risk rating companies must demonstrate to the SVS that they possess capital of USD 160,000, which must be maintained permanently. At least 60% of this amount must belong to the principal partners. The information required for company registration, both with respect to the company itself and its partners, managers and the persons who may be responsible for overseeing management of a certain rating, must be updated each time it undergoes a significant modification. In addition, the rating entities must submit their quarterly, six-month and annual financial statements, which must be signed by the entity's legal representative. The annual financial statements must be audited.

Specifically for the area of pension fund investments, the Comisión Clasificadora de Riesgos or Risk Rating Commission establishes the risk rating for certain instruments, and whether they are authorised to be acquired by the pension funds. With the new pension reform, the Risk Rating Commission establishes the equivalence between local and foreign risk ratings. This commission consists of a member of the Pensions Supervisor, a member of the SBIF, a member of the SVS and four members that represent the AFPs.

C. Equity Market

Chile's equity market is large compared to others in the region, mainly as a result of the high level of development of the Chilean private pensions scheme. Nevertheless, the equity market has remained rather illiquid, as the pension funds act largely as buy-and-hold investors, and much of Chile's corporate sector is dominated by large conglomerates with correspondingly low float ratios. Among companies in Chile's two main stock indices, an average of only 36 percent of shares is not

owned by controlling parties. Chilean companies tend to finance themselves primarily through intra-group debt and retained earnings.⁵ Some market participants consider that the tax system also encourages companies to issue debt rather than equity. Foreigners account for about 20 percent of volume traded.

The Santiago Stock Exchange (BCS)

The Santiago Stock Exchange is the country's main securities exchange and is owned by the stock brokers that operate in it. The BCS, being in the process of de-mutualisation, is now a public company, but in order to trade on the exchange, brokers need to be members of the exchange. Access to the exchange is reserved for brokers, but pension funds and insurers can trade directly on the exchange through broker screens.

The exchange lists equities, fixed-income securities, and collective investment schemes. As the regulations were primarily designed for equities, however, they do not always facilitate the trading of other instruments. Stock market capitalisation stood at USD 134 billion at the end of 2008, down about 20 percent in local currency terms from the end of 2007. The main stock price indices are the broad index IGPA (Indice General de Precios de Acciones) and the large cap index IPSA (Indice de Precios Selectivo de Acciones), which comprises the 40 most actively traded stocks.

In Chile, only liquid stocks traded on an exchange are exempt from capital gains tax. Foreign institutional investors can also benefit from this capital gains tax exemption. In order to facilitate the listing of new companies, whose stocks may start out with low liquidity, the stock exchange has created a new market segment called "Bolsa Emergente". As listings on the Bolsa Emergente segment benefit from a 3-year capital gains exemption, all IPOs are essentially done in this segment, even for larger companies.

The main recent market and products development in the case of Stock Exchanges is the introduction of a trading platform for improving the initial offering of companies' shares that let underwriters and the company assign specific portions of the offering to different kinds of investors and to fix the trading price in the IPO process up to a 10 percent below the estimated market price. This is to protect institutional investors from being prejudiced by the retail investor's practice of increasing their orders speculating that the distribution of shares will be lower than expected, in order to get more stocks. Pension funds are required to buy stocks in a stock exchange, which is why the underwriter does the IPO in the stock exchange.

The Electronic Stock Exchange

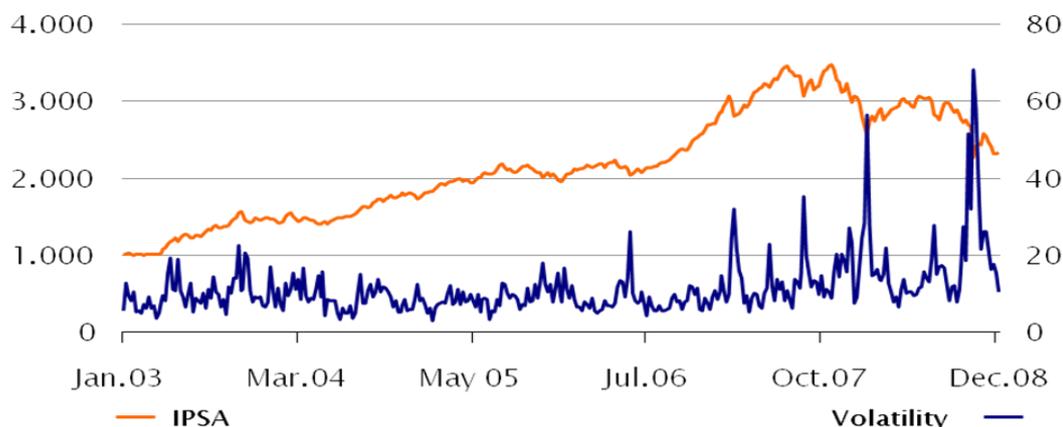
The Electronic Stock Exchange was established by the banking industry as a competitor to the BCS. As all of its members are also members of the BCS, and trading fees are the same as on the BCS, the electronic market is not very active, serving mainly as a tool for the banks to dissuade the BCS from raising its fees. The Electronic Stock Exchange estimates its market share in equities at between 10 and 20 percent. It generates additional revenue from the sale of its trading system, on which an estimated 80 percent of spot foreign exchange transactions are traded.

⁵ Some observers draw the conclusion that an important rationale for the existence of groups is to internalise imperfect and incomplete capital markets. See Agosin, Manuel R. and Ernesto Pastén H., *Corporate Governance in Chile*, Central Bank of Chile Working Paper No. 209, May 2003.

Stock market indices

The main stock exchange indices in Chile are the IPSA index and the IGPA index. IPSA index is made up of the 40 most traded firms with greater than USD 200 million in market capitalisation, reflecting 74% of overall market capitalisation, while the IGPA index essentially tracks the 138 most significant and actively traded stocks among the 238 companies listed on the market. At the end of 2008, the IPSA index had declined to levels last seen in the second half of 2006 (see Chart 2).

Chart 2: Chile – IPSA Stock Market Index (2003-2008)



Source: Central Bank of Chile

Clearing and settlement of trades executed on the exchanges

The BCS provides the service of clearing and settling stock exchange operations (denominated the System of Guaranteed Clearing and Settlement), which may also be used by other stock exchanges. This system calculates the net debt of stock brokers and arranges delivery upon payment, using the money transfer technology platforms provided by the Central Securities Depository and two commercial banks. Liquidity facilities are provided by two banks, and under a new law the Central Bank can also provide liquidity. The clearing house does not act as a central counterparty (CCP). Finally, the BCS also provides a number of back-office functions.

In the case of the Over-the-Counter market (OTC), the Central Securities Depository (which is owned by the securities exchanges, the pension fund managers, commercial banks and insurance companies) provides a platform so that its depositors can transfer money in a co-ordinated fashion with delivery upon payment mechanisms. The mechanism that makes delivery upon payment possible is provided by a Compensation Chamber for High-Value Payments (under ownership of the commercial banks), which administers the transfer instructions between the Central Securities Depository and the commercial banks involved. The OTC market consists almost exclusively of repurchase agreements.

Congress adopted, in March 2009, the "Legislative Bill on a System for Clearing and Settlement of Financial Instruments", establishing a legal framework for the operation and administration of systems for clearing and settlement of financial instruments. The objectives of this law include i) separating risk so that this function is separate from the other market infrastructure activities (one sole and exclusive line of business), ii) providing protection from seizure of assets given as guarantees while the net obligations have been calculated but have not yet been settled, iii) establishing the legal

framework that will give certainty to the process of clearing and settlement, establishing the irrevocability and finality of its operations.

Eventually the SVS wants to facilitate the establishment of a central counterparty, and mandate the use of the Central Securities Depository. On the latter, the industry has been rather reluctant, in part because of expectations that the prices for depository services may increase. It is recognised, however, that these initiatives are likely to improve the safety of clearing and settlement services in Chile.

Securitisation

The Chilean securitisation market is rather narrow, focused on credit card receivables. It is also highly regulated, with banks facing a 35 percent cap in terms of the contribution of a bank's own loans to the securitisation structure. As banks are naturally hesitant to pass client information to other banks, it has proved to be difficult to fill up the pool with loans from competing banks, and the market never really took off in Chile.

Venture Capital

Similarly, the venture capital market is not very developed in Chile. The MK II reform was designed to facilitate the development of the venture capital market, including by permitting banks to invest up to 1 percent of their capital in equity, but this has not (yet) given a significant impetus to the market.

Multiple listings

Three Chilean companies have dual listings, i.e. they are listed in Chile as well as in Mexico or Brazil. Listing abroad is possible in countries that are members of IOSCO, but for tax reasons is not considered attractive for Chilean companies.

Exchange-Traded Derivatives

In the last years, no stock exchange derivatives transactions have been made. Only one of the three exchanges has formed a derivatives clearing house. Chilean derivatives are, however, traded in the OTC market, mainly through banks and brokers. The options market is underdeveloped, as banks may not sell options on equities, although some reportedly do so indirectly through special-purpose vehicles. There is as yet no central counterparty in place, which would allow the introduction of a fully-fledged futures or options exchange segment. This should, however, become possible now under the new Clearing and Settlement Law approved in March 2009.

Collective investment schemes

Collective investment schemes have developed in Chile mainly in connection with the growth of pension funds. Initially, they mainly served as vehicles for pension funds to undertake indirect investments in asset classes such as private equity, real estate, or small- and medium-size enterprises. It is estimated that about 90 percent of investments come from pension funds. Later on, more private investors started to participate in the market by establishing more flexible "private" funds, i.e. funds with less than 51 "qualified investors", that are not required to list on the stock exchange. The Chilean mutual and investment funds sectors remain, however, relatively small, as the financial sector is dominated by banks and pension funds, and household savings outside the mandatory pension scheme are not large.

Mutual funds, which in Chile is the term used for open-ended funds, showed some growth before the world financial crisis reached Chile, but at the end of 2008 mutual fund assets were only 13 percent of GDP. Total mutual fund assets declined by 7.3 percent over the course of 2008. At the end of 2008, 65 percent of mutual fund assets were invested in fixed-income funds. Mutual funds are required to get a risk rating in order to be considered suitable for pension fund investment. In that context, the management boards of the pension funds have been assigned the task of determining the appropriate investment policy.

Table 4: Chile – Performance of Mutual Funds (2008)

Type of fund	Annual growth (2008)
Fixed-income funds (<90 days)	18.28%
Fixed-income funds (<365 days)	8.06%
Mid- and large-cap funds	-9.86%
Mixed funds	-52.43%
Capitalisation funds	-56.17%
Free investment funds	-51.29%
Guaranteed funds	5.53%
Qualified investor funds	-39.65%

Source: Association of Fund Managers (AAFMM)

Investment funds, which in Chile is the term used for closed-end funds, are attractive mainly to institutional investors such as pension funds. They benefit from a more favourable tax treatment than individual stocks.

As in many other countries, guaranteed funds have been increasingly popular in Chile, most recently the so-called “Obama funds” launched during the second half of 2008. The guarantees for such funds are typically hedged with swap structures, often within the same group. These swaps can be assumed to have gained significant market value, as stock markets have declined.

Other types of collective investment schemes in Chile are the Funds Capital Investment Abroad (FICE) and the Investment Funds Risk of Foreign Capital (FICER). FICEs are regulated by Law 18657, and are funds whose equity is made up of contributions made outside the national territory by individuals or corporations. FICEs only invest in public securities, and the investments are defined in Article 6 of the Law. FICERs also invest in securities not registered with the SVS. The administration of these funds is through Chilean incorporated companies, whose main business is the management of those funds and who require authorisation by the SVS.

In the area of real estate, there are the Housing Funds, whose equity is composed of the resources deposited by investors in saving accounts, mainly for rental housing, with a promise of sale or for voluntary savings. The manner in which the manager can invest these resources is determined by the Housing Leasing Act No. 19281. The administration of these funds is also through Chilean incorporated companies, whose main business is the management of those funds and which requires authorisation by the SVS.

The main recent market and product developments are two new businesses authorised by SVS for fund managers: (1) wealth management and investment advice for Chilean and foreign funds, and (2) the offer of fund shares as collective retirement saving (like U.S. 401k). The main objective of those measures is to improve the competitiveness of the fund management industry by letting them offer new products to their clients and offer their management services to foreign clients. The SVS is also implementing a new risk based supervision model in this area. Finally, an amendment is being developed in joint work with the Treasury, to provide more liquidity to investment funds, and permit the introduction of exchange-traded funds (ETFs) in the mutual fund industry.

D. Pension funds

Pension funds are the main institutional investors in Chile's financial markets. Pension fund assets in Chile reached, at the end of 2008, USD 74 billion, or 51 percent of GDP.

Pension Fund Administrators are stand alone sole purpose companies that can be part of financial conglomerates. To avoid potential conflicts of interest, the regulation states that the marketing and sales functions of the services provided by the Pension Fund Administrators are incompatible with the marketing and sales functions of products or services provided by any entity belonging to the same conglomerate as the Administrator. The board members, managers, executives, etc., may not hold the same posts in any and all of the firms that comprise the business group belonging to the Pension Fund Manager, and the purpose of this rule is to avoid conflicts of interest.

More details on the Chilean pension funds system can be found in the accession review report of the OECD Working Party on Private Pensions [DAF/AS/PEN/ACS(2008)2, and DAF/AS/PEN/ACS(2008)2/ADD1].

E. Commodities exchanges

Commodities exchanges in Chile are very small, and only trade agricultural commodities. In the case of Commodities Exchanges, the main recent product development was the law amendment that lets commodities brokers trade receivable accounts ("Facturas" in Spanish) in the Commodities Exchange.

VI. FINANCIAL SUPERVISION AND REGULATION

A. Supervision of Markets and Intermediaries

In Chile, financial services are regulated and supervised by different institutions according to the type of financial service. The Superintendence of Banks and Financial Institutions (SBIF) and the Chilean Central Bank are in charge of Banking, the Superintendence of Securities and Insurance (SVS) is in charge of Insurance, Fund Management, Central Securities Custody, Securities and Commodities Offering and Trading, and the Superintendence of Pensions (SP) supervises the pension system and unemployment insurance. Following the global crisis, the level of indebtedness attained by consumers in many countries and the dynamics of retail credit markets in general, the SBIF has expressed a desire to increase its supervisory authority over all relevant non-bank retail credit providers, at a similar level to the one it has for commercial banks.

The superintendences primarily act as supervisors, whereas much of regulation is fixed by legislation, giving the supervisors only very limited room for interpretation. Changes to regulation, especially on the banking side, often require a change in the respective legislation. In carrying out their duties, the supervisors' primary focus is on formal compliance with applicable laws and regulations. Projects are underway, however, to move towards a more risk-based type of supervision.

The appointment of the heads of the Regulators (except for the Central Bank) is very similar; the Chilean president chooses the head, and can freely remove him or her. There is no fixed term for the mandate of the heads of the superintendences, and their mandate usually coincides with that of the President of Chile. The superintendences are created by specific laws, and their objectives are established by those laws. Their budgets are not independent, but fall within the general government budget.

There are two entities that co-ordinate the tasks of supervisors. The first is the Capital Market Committee, headed by the Finance Ministry with the participation of three superintendences (SBIF, SP and SVS) and the Central Bank. The objective of this entity is to co-ordinate the work of and policies to be implemented in the financial sector. The second entity is the Superintendents' Committee, which was created in 2003 for solving capital market matters that require the participation and coordination of those regulators. It is composed of the heads of the three Regulators. On September 2006, an observer of the Chilean Central Bank was incorporated into the Committee. If a specific matter requires the joint work of those regulators, a working group is created with the specific objective of solving that matter adopting sometimes joint rules. The Regulators are permitted by law to share information for that purpose.

The regulatory framework defined in the Banking Law clearly establishes the activities that banks can carry out. Any activity that is not included or listed in said article may not be carried out. Banks may carry out insurance broking through affiliate companies. Likewise, banks may establish affiliate firms providing social security advice. A corporate group may establish a bank. A banking entity, however, may only get involved in lines of business established in the Banking Law, and/or through its affiliate societies in businesses defined by the Banking Law and related rules. Banking entities cannot invest in equities. However, banks may open branches or representative offices abroad, and

invest in shares of banks or companies that are established abroad which have any of the purposes authorised in articles 70 et seq., and article 74 of the Banking Act.

Securities brokers, commodities brokers, investment funds managers, stocks exchanges, commodities exchanges, central securities depositaries, credit rating agencies, securitised bond and commercial paper issuers and stock exchange and derivatives clearing houses can only carry out their main line of business and complementary lines of business authorised by the Securities and Insurance Regulator (SVS). Hence, they cannot control other corporations or companies that are not necessary for their main business, nor carry out other non authorised lines of business.

In the insurance area, there are similar restrictions: In Chile, banks cannot sell insurance directly, but have to do it through their insurance brokers. Additionally, the regulatory framework imposes regulations on ownership linkages among financial institutions, since a bank can not establish an insurance company, but needs to create another separately capitalised entity, supervised by a regulator other than the bank regulator. There are no limits on cross-shareholdings between financial and non-financial institutions, but it is necessary to comply with the aforementioned rule. The legislation allows strategic alliances, and in a particular financial group it is possible to find a bank and an insurance company, but those alliances must be between institutions with separate capital.

Banking Supervision

There are two regulatory bodies that govern the banking sector: The Central Bank of Chile, which is in charge of a number of specific regulatory tasks, and the Superintendence of Banks and Financial Institutions (SBIF), which functions as the banking supervisor. As the SBIF does not have much room for manoeuvre in regards to regulation, as it has to follow the banking law, urgent regulatory adjustments are sometimes done through the Central Bank (within the mandate of the Central Bank Law), at least on a temporary basis until the next revision of the banking law. Revisions to the banking law have turned out to be difficult, if they are considered to interfere with the constitutional right to private property.

Central Bank of Chile

The regulatory tasks assigned to the Central Bank are contained in Article 35 of the Constitutional Organic Law of the Central Bank:

- To issue regulations and establish the terms and conditions which the banking entities, financial institutions and savings and loans cooperatives shall follow with respect to borrowing from the public;
- To issue the regulations and set the limitations for banks and financial institutions on sureties and guarantees in foreign currency;
- Issue the regulations to which enterprises having as their purpose the issuance or operation of credit cards and any other similar method and which are under the supervision of the Superintendence of Banks and Financial Institutions, must conform;
- Authorise the establishment and regulate the functioning of clearing houses for bank checks and other securities in which banking entities and financial institutions participate;

In order to ensure the stability of the financial system, the authority of the Central Bank includes two essential elements: the first is the lender-of-last-resort function, where the Central Bank can

provide liquidity to banks in the case of emergency. Such liquidity provision for banks facing a temporary liquidity problem is limited for a period of no more than 90 days; the second element is the granting of credits or acquisition of assets from these same institutions when a contract with creditors has been proposed or they have been declared in bankruptcy.

In addition, the Central Bank has some regulatory authority over the payment of interest on checking accounts and credit ratios. The Central Bank also participates in regulating bank investment abroad, both in the foreign exchange sphere and in terms of financial regulation, in order to protect the interests of depositors in operations such as the purchase of shares and the establishment of subsidiaries and companies, or the regulation of financial investment, and international credits. In the latter case the Central Bank has its own powers, as well as sharing responsibilities with the Superintendent of Banks, to establish equity requirements and provisions for these sorts of operations.

Superintendence of Banks and Financial Institutions (SBIF)

The Superintendence of Banks and Financial Institutions (SBIF) is responsible for supervising and inspecting banking firms. The Superintendent is the highest authority at the Superintendence, and is named by the President of the Republic. He or she may be removed from his/her post at any moment, without any explanation of cause, and there is no minimum period for holding the post. The Superintendence's staff is chosen by the Superintendent. He or she can name the people he/she deems necessary and will determine their obligations and duties.

If legal action is taken against the Superintendent for acts or omissions when exercising his/her duty, the Superintendence must provide his/her defence. This defence shall cover all legal actions that are initiated against him/her for the abovementioned motives, even after having left the post.

Article 8 of the General Banking Law sets forth that the resources needed for the SBIF's operations come from the institutions under inspection. Given that the SBIF is a public institution its annual budget must be approved by Congress as part of the Budget Law, which is a presidential initiative. The passing of this law involves negotiations prior to its legislative process, in both the Finance Ministry and the Budget Directorate. As part of these negotiations, the SBIF proposes the amount of resources it estimates it will need each year, in accordance with its planning and needs. The Superintendent has the liberty to name and remove personnel, with complete independence from any other authority. For these purposes, all the Superintendence's personnel are considered to be of the Superintendent's exclusive confidence.

The Superintendence shall provide information about the entities it inspects to the Finance Ministry and the Central Bank of Chile. It will also make available to the public, at least three times a year, information about loans, investments and all other assets of the institutions that have been inspected and their rating and evaluation in terms of recoverability. The information must cover all the entities listed. It may also, through general instructions, oblige these companies to consistently or occasionally provide information to the public about these same matters.

The Banking Law allows the SBIF to adopt precautionary, corrective, and penalising measures that range from prohibiting certain activities that may increase the risk of an entity, to imposing fines on banks or their board members and administrators, capital requirements and the designation of provisional administrators. The SBIF also has the authority to revoke banking licenses, subject to prior agreement of the Central Bank of Chile Board. When an entity is in a situation of presumed financial instability or deficient administration, or when in exercising its inspection authority the SBIF fears for a bank's solvency, it may intervene in the institution's administration and require capitalisation, merger, sale of assets, or as a last resort, liquidation. The banking supervisor has not intervened in

banking and/or financial entities in recent years. The last intervention which led to insolvency in a group of bank and/or financial entities happened in 1983.

Box 2. Chile - Resolution of failed banks

The Banking Law empowers the SBIF to introduce, for a maximum period of six months, renewable only once for the same length of time, a wide range of requirements and restrictions on a bank's activities designed to protect its creditors, in case the bank suffers from financial instability or deficient administration. These include the reservation of independent auditors as regards the management of the entity or its stability as an ongoing enterprise. During the time that some of the measures adopted by the Superintendent are in place, no bank director or manager may resign from his office without authorisation by the Superintendent.

If a financial institution has incurred repeated infractions or fines, regularly not complied with SBIF instructions, or its economic stability could be in danger, the Superintendent has the right to designate a delegate inspector with the power to suspend any resolution adopted by the board of directors or the agents of the institution. In those same cases, the Superintendent shall have the right, with the prior consent of the Board of the Central Bank, whether or not a delegate inspector has been designated, to appoint a provisional administrator. The designation of a delegate inspector or a provisional administrator may not have a duration of over a year. The designation of a delegate inspector may be renewed only for one additional year and that of the provisional administrator as many times as the Superintendent may deem necessary.

A bank which is under any of the restrictive measures adopted by the Superintendent can be recapitalised, merged or have its assets sold during the period of time that the measures are in place. The Banking Law does not refer to a specified period in which the Superintendent has to take corrective actions. However, he is expected to exercise his powers in a timely manner and, in the extreme, may be subject to civil action for failure to discharge his duties under the Banking Law. Creditors may also sue the Chilean Government on the grounds of untimely intervention of the Superintendent.

A bank's board has to call for a shareholders meeting to recapitalise the bank if it has failed to comply with the minimum capital adequacy requirements or it seems that the bank will be in that situation in the near future. If the bank is not recapitalised within a short specified period, it will be prohibited to increase its total loans and investments. The Superintendent has discretionary power to determine whether a bank that has failed to meet an obligation is insolvent and in this case, to take corrective or remedial measures. The board of directors of an insolvent bank is required to propose a creditors agreement within ten days from the determination of insolvency. The elements of such a proposal are set out in the law, and the Superintendent is given powers to judge whether or not the proposed scheme is appropriate.

The Banking Law does not envisage the Superintendent setting up a purchase and assumption arrangement for a failed or a failing bank; or establishing a "bridge bank" pending a sale to a new owner, or arranging or assisting in finding for a merger partner for a failing or a failed bank. Some of these measures had been suggested by the IMF. The formal powers of the Superintendent in this context only cover liquidation of the bank. However, the Superintendent has considerable powers of moral suasion which may, under certain circumstances, bring about one or more of these solutions. If recapitalisation or remedial measures fail to restore the required capital adequacy, the Superintendent can determine that a bank should not continue operating and declare the bank in a state of forced liquidation. This resolution needs the approval of the Central Bank.

Under Article 128 of the Banking Law and Article 36 of the Central Bank Law the Central Bank is permitted to capitalise its credits in a bank facing solvency problems. The Central Bank is able to recapitalise banks and to sell the shares which result from this capitalisation in a period of three years.

The current solvency framework is based on Basel I and was incorporated into the Banking Act in 1997. According to the law, the regulatory capital of a bank shall not be less than 8 percent of its risk-weighted assets. Core capital may not be less than 3% of the total assets of the bank. The amount of the paid-up capital and reserves of a bank may not be less than the equivalent of UF 800,000 (around USD 28 million, end-December 2008). The SBIF published a road map for compliance with Basel II, drawn up in collaboration with the industry. In the first step, the transition towards Basel II will be through the implementation of the "standardised" approaches for credit risk, market risk and

operational risk. The Chilean authorities regard this as the most appropriate approach for a country, such as Chile, in which most banks target mainly the domestic market. In this first stage, the authorities expect banks to gain experience with modelling provisions under the rules set in 2004. This is seen to be a good preparatory exercise for a possible later move on to the more sophisticated methodologies envisaged in Basel II - the internal ratings-based approaches.

Capital Markets Oversight

The Chilean capital market supervisor is the Superintendence of Securities and Insurance (SVS). The SVS is an autonomous corporate body affiliated with the Chilean Government through the Ministry of Finance. It is responsible for the supervision of all activities and entities involved in the Chilean securities and insurance markets. The SVS enforces compliance with all laws, regulations, by-laws, and other provisions governing the operation of these markets.

Some of the supervised entities, among others, are:

- Security Issuers
- Listed corporations
- Joint-stock company
- Security Intermediaries,
- Associations of security intermediaries,
- Stock brokers, Stock exchanges,
- Mutual fund managers and the funds they manage,
- Investment fund managers and the funds they manage,
- Foreign capital investment fund managers and the funds they manage,
- Insurance and reinsurance companies established in Chile,
- Student loan funds,
- Risk-rating agencies,
- Sanitary service corporations,
- Real estate corporations,
- State-owned companies created by special laws,
- Securities and depository companies,
- Independent external auditors,
- Insurance brokers,
- Loss adjusters, Mortgage mutual fund manager agents,
- Foreign re-insurers.

The Superintendence of Banks and Financial Institutions (SBIF) is in charge of supervising all the rules of the Banking Law. The SBIF also supervises the compliance with the provisions of the Securities law, by banks and financial institutions. In the pensions area, the Pension Fund Supervisor is in charge of supervising compliance with the pensions law (DL. 3500), and the SVS has the role of supervising compliance with securities law by pension fund administrators.

The President of Chile is responsible for nominating the Superintendent and may remove him/her at will. In terms of budgetary matters, the SVS receives its budget from the Ministry of Finance but is autonomous from it. Within the limits established by the budget law, the Superintendent can carry out budgetary allocations.

The Securities Area of the SVS is in charge of supervising entities related to the securities market, such as listed corporations, issuance of securities for public offer (stocks, bonds, commercial papers, investment fund shares), stock exchanges, clearinghouses, security brokers, external auditors, mutual fund managers and their funds, investment fund managers and their funds, foreign capital investment funds and their funds, risk-rating agencies, securitisation companies, mortgage mutual fund managers and their funds, centralised security deposits, among others. The Insurance Area is in charge of supervising entities involved in the insurance market, such as insurance companies, reinsurance companies, insurance brokers, insurance adjusters, insurance agents, and endorseable mortgage mutual fund administrating agents. It is also in charge of the registry of foreign reinsurers, and both national and foreign reinsurance brokers.

Box 3. Chile – Enforcement of securities law: Two recent cases

“Inverlink Corredora de Bolsa”

At the beginning of the year 2003, motivated by information published in the press, an investigation was begun to detect possible insider trading by the General Manager of the stock broker Inverlink. During the course of the investigation, the SVS received a claim of a client for a default of 3.8 million dollar in a repurchase agreement concluded with that broker. The SVS decided to suspend the broker's operations and change the focus of its initial inspection to determine the financial situation of the broker.

A few weeks later, the SVS received a new complaint against this intermediary, in which it was accused of stealing financial instruments held in custody for its customers. The day that the claim was received, the SVS, in a joint work with the police, used its powers in order to open the broker's office and vaults, to gather information about client assets. At the same moment, the broker's partners were also charged.

After the SVS inspections, fines were applied to partners, directors and managers of the intermediary, complaints were lodged in courts and the intermediary was closed. This case is still in courts.

After this case, the law was amended to increase the powers of the SVS, and to increase penalties for hiding, altering or erasing information that could mislead an investigation, and for the use, without consent, of assets held in custody. The SVS also improved its surveillance process, moving more in the direction of risk-based supervision.

“Alfa Corredores de Bolsa S.A.”

On April 2008, the broker “Alfa Corredores de Bolsa S.A.” requested its voluntary suspension from the Stock Exchanges, for not complying with the minimum rates of liquidity and solvency required by regulation.

Knowing this broker's financial problems, the SVS initiated an investigation to determine the cause of the financial problem, how the broker was addressing them, and how well the client assets were protected. In May 2008, the SVS filed a complaint with the courts for a possible misuse of securities held in custody by the broker.

One of the conclusions of the SVS inspection was that the existing Stock Exchanges' rules for stocks repurchase agreements and custody needed to be reviewed. The SVS is still in discussions with the Stock Exchange about the possibility of requiring that securities be deposited in a central depository.

The SVS also made a rule amendment to require brokers to inform on a daily basis about their liquidity and solvency ratios (previously the basis was monthly).

Particularly in the field of insider trading, the SVS seems to have stepped up their monitoring activities in recent years, with the help of new detection software and additional staff resources devoted to this area. These efforts have brought to light several high-profile cases, some of which have already led to convictions, e.g. in the so-called “Falabella case”.

A more recent problem occurred in connection with the sale by two brokers of structured notes linked to Madoff funds. The amounts involved are not large, but the brokers reportedly are in discussions with the clients concerned about compensating them for their losses.

Conglomerates

The supervision of groups and conglomerates in Chile is complicated by the fact, described in detail above, that they are supervised by various institutions, depending on the kind of services they provide. The Superintendent’s Committee is designed to facilitate the flow of information among supervisors and with the Central Bank, including with regard to groups or conglomerates. It is unclear, however, to what degree the individual supervisors do have a good overview over the entirety of the activities of the conglomerates. The policing of the firewalls established to maintain the separation of activities has for example posed a challenge for the authorities.

The Superintendent’s Committee has been particularly active in developing common approaches to issues related to the pension system, such as the investment of pension fund resources in investment and mutual funds, including maximum commissions to be charged to the pension funds, mutual funds and investment funds, joint regulations for the Voluntary Pension Savings Plans (APV) and the newly authorised Collective Voluntary Savings Plans (APVC), a type of occupational or employer sponsored voluntary savings plan, and mortality tables for the definition of annuities reserves and payment of programmed withdrawals.

There is no legislation that explicitly gives supervisors access to information about superior or parallel structures operating at the parent bank, although the SBIF has obtained such information. The SBIF, SVS, and the Superintendence of Pensions may share information about the entities they inspect, with the exception of those entities subject to banking privacy. The companies controlled by the SVS have to report whether they belong to a business group. If it forms part of a corporate group (two or more companies), the company has to identify all the persons and entities that make up this group.

Stock exchange: Self-regulation by law

According to law, the Stock Exchanges, Commodities Exchanges and the Central Securities Depositories are self regulated organisations. The SVS is, however, empowered by law to approve their rules, restrict their business, and to inspect and fine them if they do not comply with their own rules. They have regulatory, inspection and sanction powers and they must rule and inspect their members’ activities.

Two of the three Stock Exchanges have created a common autonomous body for the purpose of a) hearing and settlement of claims arising from their members, or between one or more of them and their customers, or between a broker and the stock market, for violations of Exchange’s Bylaws, laws and regulations, and b) inspecting their members’ activities. The other Stock Exchange and the Commodity Exchange perform those activities by themselves.

The Central Securities Depository (CDS) must have an Audit Committee, in order to a) verify that the custody, clearing, settlement and transfer operations are met in full and on time, b) verify the accuracy of depositor accounts, c) verify that the information available to depositors is adequate,

accurate and timely, and d) verify the quality of the facilities and security systems, as well as the quality and amount of security and insurance. As part of its responsibilities, the Audit Committee may note any abnormalities that may arise in the operation of the Central Securities Depository and affect depositors.

Collective investment schemes: Voluntary self-regulation

The Association of Fund Managers (AAFMM), has developed a “Code of Self Regulation” and a “Compendium of Good Practices” for its member companies, covering areas such as ethical values, healthy competition, cooperation with the community, good faith in relations among members, the dissemination of truthful information to the public, and the sanctions applying to those who violate the principles stated in the compendium. Specifically, self-regulation covers areas such as advertising, disputes between suppliers, and a host of smaller problems, as well as a complaints procedure. The SVS has constantly been in close contact with the association in the process of developing new regulations. The AAFMM has also conducted various training sessions for its member firms, including on regulatory compliance.

In the area of closed-end funds, the law calls for the establishment of a Surveillance Committee, to ensure the representation of the interests of the members of these funds in relation to the management of the administrator. The main obligation of this Committee, which consists of representatives of the contributors to the fund, is to ensure that the operations are made in accordance with the laws and internal regulations of the fund. The Surveillance Committee has to be composed of an odd number of representatives of the fund's contributors (not necessarily contributors), elected in ordinary assembly, which cannot be persons related to the administrator. These representatives serve a one-year term in office, may be re-elected, and are paid from the fund, as determined in the respective rules of procedure.

Planned changes in capital market regulation

Acknowledging that the Chilean financial system is not as open as it could be, the Chilean finance minister, in August 2008, announced a third capital market reform package, known as “MKIII” (see Box 3). Due to the world financial crisis, the MKIII package has now been shelved for an indefinite period of time. Some of the measures that did not require legislative changes have nevertheless been implemented.

For international investors, one of the most interesting parts of the package would have been the items listed under item 3 (“*A market that is more internationally integrated*”), as these could have resulted in the removal of barriers to the further international integration of the Chilean financial system. Whereas capital gains tax has for example been effectively abolished for (liquid) stocks, foreign investor are at this time still subject to a 35 percent capital gains tax rate on fixed-income instruments. This requirement has had the result that there is almost no foreign participation in the domestic fixed-income market. Chile has recently introduced a new type of bond which is not subject to capital gains tax, but where international investors have to pay a tax of 4 percent on every coupon paid. Furthermore, the Ministry of Finance, formally requested the Central Bank to permit the peso to be used as a means of payment in international financial transactions, rather than only as a denomination, and to permit the denomination of foreign securities in pesos. A decision of the Central Bank Council is pending. The Central Bank Law restricts the use of the local currency in settling most capital account transactions with non-residents, resulting, according to the IMF, in a segmentation of the offshore and onshore derivative markets.⁶

⁶ This issue is further discussed under Chapter VII.B. below.

Another reform that was contemplated under MKIII was the granting of more autonomy to the SVS. One idea that had been floated in this respect was the creation of two new bodies within the SVS, Council of Directors that would be responsible for norms, investigation and supervision of insurance and securities, and a separate “Securities and Insurance Court”. The members of both bodies would be chosen by the President of Chile from a list of three candidates to be proposed by an independent Civil Service Commission. The terms of its members would be staggered and not coincide with that of the Chair, to reduce the possibility of political influence. The members could only be removed through a decree explaining the reasons for the removal, and with prior approval by the Comptroller General.

Box 4. Chile – Plan for a Third Capital Market Reform (MKIII) 2008

In August 2008, the Finance Ministry announced the central content of a third Capital Market reform (MKIII), which includes legislative bills, administrative measures, and initiatives for public-private co-ordination. The central objective of MKIII, according to the authorities, is to develop the securities market, ensuring a full integration with global markets and helping Chile become an exporter of financial services. Another objective of the reform is to open the securities market to smaller-size companies, developing new instruments and ways for them to access the market. In light of the world financial crisis, this plan has now been postponed indefinitely.

1. A deeper market with greater liquidity: The regulation should reflect a financial reality that is increasingly versatile and dynamic, and should resolve asymmetries in information and facilitate the development of new investment alternatives. This involves updating the rules to ensure fair competition with all other markets. With the objective of moving toward a deeper market with greater liquidity, other measures are also proposed: i) changes to facilitate and make more flexible the establishment and administration of mutual funds and investment funds, ii) a clear and common framework for taxing debt instruments is established, iii) tax benefits for payment transactions of mutual funds and fixed-income instruments that fulfill certain requirements.

2. Broader market, with greater access for small and medium-size enterprises: The reform is designed so that small and medium-size companies can have access to financing in the financial market, which will promote greater competition, more advantageous conditions and increased stimulation for innovation and entrepreneurship. This will be done i) supporting securitised bonds with partial guarantees whose underlying elements shall be small and medium-size enterprise credit portfolios and leasing contracts for that sector; ii) creating a legal framework for developing a high-yield bond market, especially for small and medium-size enterprises; iii) modification of the rules for facilitating the securitisation of future flows.

3. A market that is more internationally integrated: The reform is meant to take advantage of Chile's comparative advantages to facilitate investments and the export of financial services to other Latin American countries. The objectives of these modifications are: i) broaden the tax benefits (capital gains) to more instruments and to more foreign institutional investors such as foreign insurance companies, sovereign funds and endowments, etc. (already implemented); ii) homologate tax rates on interest paid on loans from non-bank financial institutions with those applied to foreign bank credit (4%); iii) eliminate the 15% limit of foreigners as specialised technical personnel working at financial market companies; iv) facilitate the transaction of foreign securities in Chile, taking advantage of rules already dictated by the SVS; v) elimination of taxes on exports of financial services; vi) allow different types of foreign securities to be expressed in pesos, under the conditions determined by the Central Bank of Chile; vii) simplification of tax paperwork for investors not domiciled or resident in Chile with respect to obtaining income.

4. A market that is continually perfected: The capital market needs to be continually perfected, and this requires leadership, co-ordination, and persistent efforts. For this, the reform proposes: i) make the consistent concern for financial competitiveness a priority for the Capital Market Committee; ii) set up a Capital Market Consultative Council, comprised of experts with financial experience, who will evaluate the appropriateness of reform initiatives and propose the perfections that they deem necessary; iii) organise public-private road shows to demonstrate the strengths and opportunities of Chile's capital market in international financial markets; iv) changes in the Superintendence of Securities and Insurance's institutional structure to improve its independence and autonomy.

Source: Ministry of Finance

B. Financial Stability Oversight and Macro-Prudential Surveillance

The institutions responsible for safeguarding the economy's proper functioning are the Finance Ministry and the Central Bank. The Finance Ministry coordinates all the government's duties related to the economic sector, while the Central Bank not only implements monetary policy, but also is legally mandated to oversee the normal operation of domestic and external payments. The Central Bank also has a regulatory role, especially in regard to the banking system and to foreign exchange matters. The financial sector superintendences are responsible for monitoring the institutions under their surveillance.

The oversight duties carried out by the superintendences include stress tests. The SVS carries out stress tests for the insurance industry. As part of its Financial Stability Report, the Central Bank undertakes stress tests every six months, in coordination with the SBIF. Currently, there are two stress tests, one for the corporate sector and other for the banking sector. Although both tests are based on the same scenarios, they are calculated separately. A third stress test on households is under development. The credit risk stress test is computed using a model that relates provisions, write-offs, and loan growth with macrovariables such as the output gap and short-term interest rates. The specification is a non-linear dynamic model for the banking system as a whole

Regarding the stress test on the banking sector, the elements used stem from a macroeconomic model in which an interest rate shock with effects on the output gap is simulated. In addition, currency depreciation is considered. Thus, the interest rate term structure and the output gap have effects on the valuation of financial assets and on provisions. The main indicators analysed are return on equity, the capital adequacy ratio, the leverage of the banking system, and provisions.

There is no explicit crisis resolution procedure or memorandum at the moment, but the financial authorities are developing a plan in which the functions and responsibilities of each of the involved institutions will be explicitly defined. The resolution of extreme events or crises are analysed on a case-by-case basis. For example, in the context of the current international crisis, the Committee on Capital Markets, which is more of a policy-focused committee, has met approximately twice a month since August 2008. These meetings include a review of recent data, with a special emphasis on local and international events. Discussions are held about the local scenario, and proposed policies are analysed and implemented in order to confront the current situation.

C. Financial system support measures

Deposit guarantee scheme

The deposit guarantee scheme applies to all banks – domestic and foreign – and has no cost for these entities. According to the Chilean authorities, the guarantees cover all banks authorised to operate in the domestic market, including branches of foreign banks.

1. The Chilean government guarantees saving accounts and time deposits. This guarantee benefits individuals only, and covers 90 percent of the obligations that the financial system has contracted with an individual. The coverage has a ceiling of UF 108 (USD 43,760 as of end-December, 2008). The system is not pre-funded.
2. The Central Bank guarantees the total amount of sight deposits and obligations received or contracted by a banking enterprise. Sight deposits and obligations are those whose payment may be legally demanded in an unconditional manner, immediately, except when the depositor or creditor is another banking enterprise since in such case the

deposits, loans or obligations shall always be deemed as time obligations. Banks are required to hold central bank securities against sight deposits in excess of 2.5 times their own funds.

Other measures

In response to liquidity shortages, the central bank suspended the programmed purchase of USD in the foreign exchange market in the context of its reserve accumulation program. It also introduced a swap program, with weekly auctions of USD 500 million, with a potential for a maximum of USD 5 billion. The Government announced an increase in USD deposits in the banking system for USD 700 million to be allocated through auctions performed by the Central Bank. In addition, the Central Bank introduced additional flexibility for reserve requirements, permitting that they be constituted in euro and yen in addition to dollars. Finally, the Bank also made adjustments to the annual program for managing Central Bank debt.

In order to avoid a credit crunch and maintain access to bank lending, the government is considering various further measures. One measure that has already been initiated is the expansion of the activities of the Guarantee Fund for Small Enterprises (FOGAPE). This fund, which is administered by BancoEstado and has received additional funding in the amount of USD 130 million (which can be leveraged 10 times), guarantees a percentage of bank lending to small enterprises. It has temporarily received authorisation to extend lending also to medium-sized enterprises. Other measures being discussed include partial guarantees for asset-backed securities (assets being credits of SME) or more coverage (up to 90 percent) to the guarantees already established.⁷

D. International Surveillance Assessment of Chilean Financial Supervision

Chile regularly receives visits from and cooperates with international organisations, including on studies and reports relating to the financial system. The most recent assessments of Chile's financial system include the one done by the IMF and World Bank under the Financial Sector Assessment Program (FSAP) between June and July of 2004.⁸ Chile's financial system was found to be sound, resilient to shocks, and well supervised. Bank competition was considered still limited, although on the rise.

The Chilean authorities have undertaken a number of measures to implement the reform suggested in the FSAP. In the area of anti-money laundering, Chile adopted a new law that the authorities consider resolved the issue mentioned in the FSAP. As discussed above, the securities markets infrastructure has also been modernised, and further efforts are underway. The legal protection of supervisors was strengthened in the context of the MKII package, and the disclosure of information was improved in the context of the move to IFRS.

Capital requirements for market risk were also implemented, although not through a revision of the banking law, but through a central bank regulation. On a number of other issues, it is not clear yet as to how far they have been addressed. Specifically, the FSSA report advocated a move to full consolidated supervision, and a strengthening of the financial and legal autonomy of the supervisory agencies.

⁷ Chile has also, on a temporary basis until the end of 2010, and within certain limits, relaxed the regulatory capital charges on assets guaranteed by the State, CORFO, and FOGAPE, by permitting banks to count up to 15 percent of such guarantees as capital.

⁸ The possibility of an FSAP update in 2009 is under discussion with the IMF.

VII. INTERNATIONAL FINANCIAL INTEGRATION AND MARKET ACCESS⁹

A. Recent Developments in Cross-border Investment

Foreign institutions and individuals participate in the local capital markets. The authorities, on the basis of Central Bank of Chile figures, estimated their net portfolio investment at about USD 9.3 billion as of year-end 2007, or about 5.7 percent of GDP. Pointing out that this number almost certainly overstates the presence of foreign investors on the BCS, as not all foreign investment is in listed companies, the authorities calculate a lower floor of USD 3.8 billion for the stock of foreign investor listed equity ownership (on the basis of flow data between January 2002 and March 2008). Local analysts estimate the share of equity market capitalisation belonging to foreigners at only around 5 percent, whereas the participation of foreigners in the local fixed-income market is apparently close to zero.

B. Internationalisation and Capital Market Regulation

The participation of foreigners in the Chilean banking system is substantial, with two of the five largest banks (including the largest one) being foreign-owned. According to the Central Bank of Chile, foreign-owned banks had a market share of 41 percent at the end of 2008. These foreign-owned institutions are also, through companies within the same group, important players in other parts of the financial sector, including pension funds and insurance.

Despite the substantial presence of foreign investors, Chile's currency, the peso, is characterised by a low degree of internationalisation. According to BIS data, the volume of spot cross-border transactions is very small. In the latest Triennial Central Bank Survey for April 2007, dealers reported an average daily trading volume of only USD 92 million. The main way for foreigners to access the Chilean market appears to be through non-deliverable forwards (NDFs), rather than through contracts where currency is actually delivered. This is likely related to the Central Bank Law restricting the use of local currency in settling capital account transactions with non-residents. The Central Bank itself cites the administrative and transaction costs necessary for non-resident investors to effect spot and derivatives transactions with physical delivery in the local market, specifically the process of opening bank checking accounts for non-residents.¹⁰

Article 39 of the Constitutional Organic Law (COL) of the Central Bank establishes the freedom of any person to engage in foreign exchange transactions. Notwithstanding this provision, the Central Bank may require, on a non-discriminatory basis, that certain transactions be conducted exclusively through the Formal Exchange Market (FEM), and/or be reported. The FEM consists of all banks plus

⁹ This section, while covering broader issues of international financial integration and market access, includes references to issues raised by the OECD Investment Committee in its meeting of 16 December 2008, as far as they concern financial markets. The Accession report of the Investment Committee is available under DAF/INV/ACS(2008)1.

¹⁰ Chile has not proposed to lodge a reservation in this respect under the Code of Liberalisation of Capital Movements.

authorised agents. To become part of the FEM an entity must be incorporated in Chile. The current regulations of the Central Bank require that operations in derivative instruments with non-residents and in derivative instruments referenced to a foreign underlying with the entities constituting the FEM be conducted in the FEM. As non-resident agents may not form part of the FEM and perform certain operations for residents, this represents a restriction to the cross-border provision of financial services, and Chile has accordingly proposed to lodge a reservation under item E/2 (Banking and Investment Services) of the CLCIO.¹¹

Chile has lifted most capital controls, although the Central Bank retains the power to introduce such controls under its Constitutional Organic Law. Chile has formally confirmed to the Investment Committee its understanding that, in accordance with Article 4 of the Codes, an eventual invocation of Article 7 or other safeguards would not alter the obligations undertaken by Chile under Article VIII of the Agreement of the IMF and that the application of any new foreign exchange restrictions which might be introduced pursuant to Articles 49 and 50 of the Central Bank's Constitutional Organic Law shall not discriminate between OECD countries, in accordance with the provisions of Article 7e. of the Codes and the Central Bank's own rules.

Listing of foreign securities in Chile

With the 2007 capital market reforms (MKII), the SVS received the authority to ease the requirements and conditions governing the register and posterior public offer of foreign securities in Chile. The new rules also authorise the SVS to exempt certain foreign securities from the obligation of being registered. Exempted securities are those from issuers under the supervision of entities with which the SVS has signed collaboration agreements (see "exchange of information" below). In mid-June 2008, the SVS established the requirements for the public offering of foreign shares in Chile, and the titles or certificates that represent these shares, simplifying the procedure and lowering the administrative burden.¹²

Chile confirmed, at the meeting of the OECD Investment Committee on 16 December 2008, that the rules for recognition of foreign securities markets are maintained and enforced only to ensure the effective application of prudential controls for investor protection purposes and do not discriminate among OECD Member countries. Chile furthermore committed to grant authorisation and to issue guidelines regarding registration requirements for additional types of foreign securities when a request is made for the introduction, on the domestic market, of foreign securities covered by items IV (capital market securities), V (money market securities), VI (other operations in negotiable instruments and non-securitised claims) and VII (collective investment securities) of the Code of Liberalisation of Capital Movements.¹³

The Investment Committee requested further confirmation from the Chilean authorities however, that it is possible for a foreign issuer to make a primary issue on the Chilean market so that no

¹¹ The OECD Investment Committee, at its meeting on 16 December 2008, considered that the list of reservations to the Code of Liberalisation of Current Invisible Operations regarding the provision by non-residents of banking and other financial services in Chile was long and that the scope of the reservations should be narrowed, in particular when users of financial services are corporate entities or sophisticated investors and for items D/2 and D/4 and E/2 to E/5.

¹² The list of recognised securities markets can be found in Annex I of SVS General Regulation No. 217. (http://www.svs.cl/normativa/ncg_217_2008.pdf).

¹³ A list of recognised markets for collective investment securities can be found in Annex I of SVS General Regulation No. 241, published on 22 January 2009. (http://www.svs.cl/normativa/ncg_241_2009.pdf).

reservation in this area will be needed. Chile, by not lodging a reservation regarding introduction of foreign securities, indicates that its authorities stand ready to provide non-discriminatory treatment for registration of foreign securities by issuance of the appropriate registration regulations. The Investment Committee also inquired about the exact criteria for attaining “recognised market” status, which is required for introduction of foreign securities on the domestic market, the authorities' availability to establish a memorandum of understanding with securities regulators of OECD Member countries in order to facilitate the introduction in Chilean securities markets of depository receipts for foreign securities. Chile explained that, to meet the recognised market requirement, the foreign market regulator must be a member of IOSCO and meet standards similar to those prevailing for Chilean markets regarding investor protection and transparency. Securities supervised by a regulator that is a member of IOSCO, but that comes from a market that does not meet the other recognised market requirements, can only be admitted for offer in Chile to qualified investors. Finally, Chile confirmed that any interested party may place securities in custody with domestic banks and may, thereby, proceed to register depository receipts for foreign securities for their introduction for trading in Chilean securities markets.¹⁴

Access of residents to foreign markets

While beyond the asset allocation rules for pension funds, there are few formal barriers to investment abroad, outside the pension fund sector investment in foreign markets remains small. This can in large part be explained by the high degree of inflation indexing in the Chilean economy, and the asset matching requirements of financial institutions, which have to match their UF-indexed liabilities with UF-indexed assets. Although it is possible to swap foreign currency investments into UFs, some investors shun the costs and counterparty risks this involves. Flows into foreign markets by pension funds have increased as a result of the raising of foreign investment caps, although in the current environment the authorities have on the contrary been observing a repatriation of capital.

Chile maintains a registration procedure for the issue of certain domestic securities on foreign markets. Chile confirmed, at the meeting of the OECD Investment Committee on 16 December 2008, that this registration procedure does not amount to a prior authorisation requirement. Chile furthermore confirmed that the operations that Chilean securities brokers may perform for their customers on foreign markets correspond with items IV (capital market operations), V (money market operations) and VII (operations in collective investment securities) of the Code of Liberalisation of Capital Movements and that Chile is willing to commit to liberalisation of these operations.

Exchange of information

In the banking sector, the exchange of information with foreign supervisors is authorised by Article 82 of the Banking Law: *“These agreements [of supervision] may authorise inspection institutions to share, in a reciprocal manner, reserved information about firms that operate in both countries and are linked in that one is the controller of the other. The agreements shall stipulate that confidential information provided to foreign inspectors shall be subject to the same confidentiality to which it is subject in Chile. In no case may the Superintendence provide information subject to banking secrecy, pursuant to paragraph one of Article 154.”*

The SBIF has signed memoranda of understanding with the supervisory authorities of Argentina, the USA (FED, OCC, and FDIC), Spain, and the Dominican Republic. The nature of these agreements consists of an exchange of information between supervisors, except for matters subject to banking privacy. Likewise, Article 29 requires that in order to authorise foreign banks to carry out

¹⁴ Items IV/A, V/A, VI/A, VII/A of the Code of Liberalisation of Capital Movements.

operations in Chile, either through a branch or with a share in a Chilean bank, there must be a possibility of exchanging information between the home and host country supervisors. However, a memorandum of understanding is not a prerequisite in order for the co-operation agreement to be signed. There are, according to the authorities, no legal impediments in Chile for foreign supervisory authorities to carry out in situ inspections of foreign banks with offices in Chile, except for matters relating to banking privacy.¹⁵

In the securities and insurance areas, the exchange of information with foreign supervisors is also subject to confidentiality regulations, which may be considered as an obstacle to the exchange of information between domestic and foreign supervisory authorities. Article 23 of the SVS Charter provides that *“The employees or persons that under any title lend services to the SVS will be bound to confidentiality regarding the documents and information of persons or entities subject to the SVS’ supervision when said documents or information are not public. The breaking of this obligation will be sanctioned in the manner established in the first point of article 247 of the Penal Code. The stipulations of the previous point will not prevent the Chairman from publishing or making public through the persons or means he deems appropriate, information or documentation regarding supervised subjects in order to protect the public trust and the interests of shareholders, investors and the insured.”* Pointing out that the secrecy restrictions apply only to depositors, Chile states that the prohibition to share information subject banking secrecy or relating to banking privacy does not represent an obstacle to the exchange of relevant information with foreign supervisors.

The subscription of a MoU is not a prerequisite for cooperation and exchange of information that the SVS is allowed by law to share. The SVS is permitted, under its Charter, *“to come to agreement with other public services and organisations of the State regarding the electronic transfer of information in order to facilitate the fulfilment of its functions. At the same time and before a resolution set forth by the Chairman, it may establish this interconnection with private organisations or institutions. Likewise, it may establish this interconnection with foreign public organisations or international organisations, with which it concludes agreements or memoranda of understanding”*.

The SVS actively participates in IOSCO, where the Superintendent is currently the chairman of the Emerging Markets Committee, IAIS, ASSAL (Association of Latin American Insurers Regulators) and COSRA (The Council of Securities Regulators of the Americas). The SVS is not a signatory of IOSCO’s multilateral MoU but is studying the possibility of signing the IAIS multilateral MoU. So far, the SVS has signed 24 MoUs (see table below).

¹⁵ Bank privacy rules are very strict in Chile, and the authorities need to obtain a court order to lift confidentiality.

Table 5: Chile – Memoranda of Understanding signed by the SVS (end-2008)

MEMORANDUM OF UNDERSTANDING

	<i>Entity</i>	<i>Jurisdiction</i>	<i>Date</i>
1	Comisión Nacional Bancaria y de Valores	Mexico	31-III-91
2	Comisión Nacional Supervisora de Empresas y Valores	Peru	30-I-92
3	Comisión Nacional de Valores	Argentina	28-IV-92
4	Comisión Nacional de Valores	Costa Rica	24-IX-92
5	Superintendencia de Valores	Colombia	2-II-93
6	U.S. Securities and Exchange Commission	USA	3-VI-93
7	Comisión Nacional de Valores	Paraguay	13-VII-93
8	Comisión Nacional del Mercado de Valores	Spain	25-X-93
9	Superintendencia de Compañías	Ecuador	28-VII-95
10	Securities y Exchange Commission	Thailand	6-XI-95
11	Comissao de Valores Mobiliários	Brazil	21-VI-96
12	Autorité des marchés financiers	Quebec	18-IX-96
13	Financial Services Authority	United Kingdom	15-X-96
14	Superintendencia de Valores	El Salvador	27-VI-97
15	Securities Commission	Malaysia	26-V-98
16	Financial Services Board	South Africa	26-V-98
17	Financial Supervisory Commission	Taiwan	26-V-98
18	Autorité des marchés financiers	France	27-V-98
19	Superintendencia de Pensiones, Valores y Seguros	Bolivia	4-VI-98
20	Comissao do Mercado de Valores Mobiliarios	Portugal	20-IX-01
21	U.S. Commodity Futures Trading Commission	USA	12-IX-02
22	Superintendencia de Valores	Dominican Republic	23-IX-02
23	Comisión Nacional de Valores	Panama	28-IX-04
24	Comission de Surveillance du Secteur Financier	Luxembourg	25-I-08

Source: SVS

Market Access for Foreign Institutions and Investors

For securities brokerages and other entities that offer non-bank financial services, foreigners do not currently have the option of establishing a branch in Chile. Securities brokerages, securities exchanges, securitisers, commodities exchanges, commodities exchange brokers, clearing houses, risk rating companies, and securities depository and custody entities must be companies established following Chilean legislation, and the directors, administrators, managers, or legal representatives must be Chilean or residents of Chile. These requirements also apply to companies that manage mutual funds, investment funds, housing funds, foreign capital investment funds (FICE), and foreign risk capital investment funds (FICER). The latter two only have to be managed by a legal representative domiciled in Chile, if they are created by foreign institutional investors.

Securities brokerage services, commodities brokerage services, investment funds management, stocks exchanges services, commodities exchanges services, central securities depository services, securitisation process and stock exchange derivatives clearing house services can only be carried out by enterprises incorporated in Chile. Similarly, credit rating services can only be performed by Chilean corporations (partnerships). Chile has requested corresponding reservations under item A,I/A i) of the CLCM.

According to several of Chile's free trade agreements, Chile shall allow financial institutions (other than a trust company or insurance company) organised outside its territory to provide investment advice and portfolio management services, excluding (1) custodial services, (2) trustee services, and (3) execution services that are not related to managing a collective investment scheme, to a collective investment scheme located in Chile. They may, however, be required to register and be subject to prudential regulation. In order to provide MFN treatment, Chile's proposed reservation on item E/4 (asset management) of the CLCIO has been narrowed to exclude asset management services for investments abroad offered in Chile by non-residents to resident fund managers.

The directors, administrators, managers, and legal representatives of stockbrokers and securities agents are required to have Chilean nationality or must be in possession of a residence permit. There is also a maximum quota of 15 percent of foreigners who can work as specialised technical personnel at financial market companies, unless these are considered irreplaceable by Chilean workers. A draft bill, which was expected to be presented to the Congress in September 2009 and to become law during 2009, includes an amendment to the labour regulation that would remove the 15 percent cap.

Representative offices of foreign banks are subject to prior authorisation, and according to Article 33 of the Banking Law, such authorisation can be revoked at any moment if their maintenance is found to be "inconvenient". This limitation is reflected in a proposed reservation under item E/7 of the CLCIO.

Chile, as a member of the WTO, is a member of the General Agreement of Trade in Services (GATS). In the GATS, Chile has undertaken commitments regarding disciplines such as Market Access and National Treatment in relation to banking, insurance and other financial services, mainly in Mode 3. However, Chile is not part of the Understanding on Financial Services. Furthermore, Chile has included Financial Services Chapters in various Preferential Trade Agreements, with the United States, Japan, the European Communities, Canada and Australia. Disciplines such as right of establishment, national treatment and transparency are among those that are included in these Chapters.

As a general policy, Chile liberalises financial services on a unilateral basis as this is seen as the first-best policy for a small-economy. According to the Chilean authorities, only in very limited cases,

e.g. marine, aviation and transport (MAT) insurance in the US and EU trade agreements and branching with specific capital in the US trade agreement, has Chile lifted existing restrictions on international trade in financial services in an agreement. Thus, any further liberalisation will be, as a matter of principle, done on a unilateral, and MFN, basis. Cross-border supply of financial services is in general restricted unless it is done at the initiative of the consumer. The exceptions are mainly MAT insurance and reinsurance, items on which Chile has not proposed a reservation under the Codes.

Banks, insurance companies and financial institutions in general must be established in Chile in order to perform their business in Chile. Banks and insurance companies may also do so through branches of foreign corporations; however, those branches must operate with their own capital, separate from that of its parent, which must be effectively invested in Chile. Furthermore, in transactions between a branch and its main office abroad, both are considered as independent entities. Such branches can perform the same banking or insurance activities allowed to Chilean banks or insurers and foreign banks or insurers established as subsidiaries, as well as other financial services authorised under the General Banking Law or the Insurance Law and/or by the Superintendence of Banks and Financial Institutions (SBIF) or Superintendence of Securities and Insurance (SVS), respectively. The General Banking Law and the Insurance Law also establish that such branches are subject to the same prudential and legal requirements as Chilean-owned banks or insurers and foreign bank subsidiaries or subsidiaries of foreign insurance companies. However, branches, unlike subsidiaries, do not have to have a board of directors in Chile.

Additionally, juridical persons supplying financial services and constituted under the laws of Chile are subject to non – discriminatory limitations on juridical form. For example, partnerships (*sociedades de personas*) are generally not acceptable juridical forms for financial institutions in Chile. Foreign financial providers (branches, subsidiaries) enjoy national treatment in Chile with respect to all elements of the regulatory system, as there is no distinction/discrimination between domestic and established foreign suppliers established in Chile.

VIII. COMPLIANCE WITH THE OECD LEGAL INSTRUMENTS ON FINANCIAL MARKETS¹⁶

C(2009)62 and C(2009)62/CORR1: Recommendation of the Council on Good Practices on Financial Education and Awareness Relating to Credit

Chile accepts the recommendation.

Three governmental institutions perform activities regarding financial education and awareness regarding credit. The first one is the Superintendency of Banks and Financial Institutions (SBIF) which regulates banks and credit cooperatives. The second one is the Superintendency of Securities and Insurance which regulates insurance companies which, in addition to banks and credit cooperatives give credit to individuals. The third one is the National Consumer Service (SERNAC). In addition, there is a bill in Congress that will reform the provision of credit information which involves financial information sharing platforms.

The Superintendency of Banks and Financial Institutions

In the area of banks and credit cooperatives, the SBIF has adopted and implemented most of the recommendations contained in this OECD instrument. Of those not yet adopted, the SBIF can implement gradually those regarding the inclusion of a box in loan or credit agreements that clearly summarise the terms and conditions of the product (paragraph 15 of the Annex to the Recommendation) and the disclosure on mortgage agreement of relevant information (paragraph 45). Regarding effective interest rates, there is currently a bill in Congress that reforms the law on Protection of Consumer Rights that will make the reporting of the annual percentage rate compulsory.

The Superintendency of Securities and Insurance

Regarding loans provided by insurance companies, the SVS has issued a norm that contains provisions concerning transparency of the information to be provided to the public in general and to borrowers. They mandate that insurers must maintain physically visible the information on the terms and conditions for the granting of loans, which at a minimum has to contain complete and clear information on the interest rate applied according to unit of account, amount lent and repayment period. In addition, insurers must provide their clients a written summary of the conditions of the loan granted and the installments of the loan.

The National Consumer Service (SERNAC)

The SERNAC plays an important role in enforcing those provisions of Law 19,496 on Protection of Consumer Rights when it comes to credits. In that regard, please refer to Chile's comments to

¹⁶ Chile's complete submission on all the legal instruments except C(2009)62 can be found in Chile's Initial Memorandum, the relevant excerpt of which is made available to the Committee [DAF/CMF/ACS(2009)4]. Chile's submission on C(2009)62, which was adopted after the submission of the Initial Memorandum, is set out below.

instrument C(77)39, Recommendation of the Council Concerning Consumer Protection in the Field of Consumer Credit.

The bill does not currently include the issue raised in paragraph 36 of the Annex to the Recommendation according to which the action of comparing options and requesting quotes from various institutions and/or intermediaries should not be detrimental to the consumer credit history, score or rating. However, the issue of credit scoring in general may be regulated in an addition to the bill, based on the UK's Guide to Credit Scoring.

C(2005)55/Rev1: Recommendation of the Council on Principles and Good Practices for Financial Education and Awareness

Chile accepts the recommendation.

More details on Chile's initiatives in the area of financial education can be found in Chile's Initial Memorandum.

C(75)198: Recommendation of the Council concerning Minimum Disclosure and Procedure Rules to be Complied with before Securities may be Offered to the Public

Chile accepts the recommendation.

Chilean regulation is generally consistent with the Recommendation. Chile's regulatory framework does not, however, require the following specific items of information: a declaration of responsibility by external auditors and report on the financial information contained in a prospectus; a summary of loans and guarantees granted to a company's directors and its principal executives; the fees paid to intermediaries or agents responsible for the placement of the securities; a summary of financial information for the previous five years (in Chile, only the previous two or three years are required depending on whether shares or debt, respectively, are being issued); or, interim financial statements for important subsidiaries (in Chile, this information is disclosed on a permanent basis only if the subsidiaries are registered). The Chilean authorities note that despite these differences, there are, in general, no legal or administrative restrictions to prevent Chile's adoption of disclosure norms such as those of the OECD.

Moreover, the SVS can request issuers to complement information contained in a prospectus if it deems this to require clarification or greater detail and can, in addition, strengthen disclosure requirements by issuing new norms.

C(74)157: Recommendation of the Council concerning Regulations for the Public Offer and for Stock Exchange Listing or Quotation of Foreign Securities

Chile accepts the recommendation.

The SVS is in the process of modifying the regulation on the registration of securities. By recognising that issuers of overseas securities already comply with registration requirements, procedures for the exercise of rights and disclosure requirements similar to those existing in Chile, these modifications are designed to facilitate their offer to the public in Chile. In the case of countries specifically recognised by the SVS for this purpose, these can be offered to the public in general while, in the case of issuers from countries where disclosure requirements may be less stringent or risk may be higher, they can be offered only to qualified investors who, because of the nature of their

business, the characteristics of their mandatory and the amount of their investments, may be assumed to have the necessary profile, knowledge and experience to participate in these markets.¹⁷

C(74)156: Recommendation of the Council concerning Disclosure Requirements and Procedures to be Applicable to all Publicly Offered Securities

Chile accepts the recommendation.

A bill on corporate governance including provisions to increase the transparency of the information disclosed by issuers of securities and the participation of shareholders, particularly minority shareholders, in company decisions, and which was referred to in Chile's Initial Memorandum (see Annex I) is still under discussion in Parliament.

C(74)61: Recommendation of the Council concerning the Review of any Restrictions which Member Countries Impose on Portfolio Investment in Unlisted or Unquoted Securities

Chile accepts the recommendation subject to two observations and a reservation.

Chile notes that (1) Chilean banks are not permitted to invest in variable-income assets on their own behalf, either directly or indirectly; (2) all transactions involving foreign securities carried out with assets managed by pension funds must be channelled through a formal secondary market authorised by the Central Bank of Chile, and (3) transactions involving unlisted or unquoted securities must comply with regulatory requirements on monetary, credit, financial and foreign exchange matters maintained or adopted by the Central Bank of Chile in accordance with its Constitutional Organic Law (Law 18,840 of 1989) or other legislation in order to ensure currency stability and the normal operation of domestic and foreign payments.

C(71)234: Recommendation of The Council concerning Standard Rules for the Operation of Institutions for Collective Investment in Securities

Chile accepts the recommendation.

Chile furthermore considers that its legal framework is consistent with the recommendations in the White Paper on Governance of Collective Investment Schemes (CIS) OECD March 2005.

C(71)176: Recommendation of the Council on International Security Issues

Chile accepts the recommendation subject to three reservations.

Chile notes that (1) Chilean banks are not permitted to invest in variable-income assets on their own behalf, either directly or indirectly; (2) pension funds regulated by Decree Law 3.500 (1980) are subject to an upper limit on their investments in overseas assets, and (3) operations involving international securities must comply with regulatory requirements on monetary, credit, financial and foreign exchange matters maintained or adopted by the Central Bank of Chile in accordance with its Constitutional Organic Law (Law 18,840 of 1989) or other legislation in order to ensure currency stability and the normal operation of domestic and foreign payments.

¹⁷ For more details on the listing of foreign securities in Chile, see paragraph VII.B. above.

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ANNEX I

ESSENTIAL ASPECTS OF THE BILL FOR CHILE'S THIRD CAPITAL MARKETS REFORM (MKIII) 01.09.2009

This new capital markets reform seeks to promote competition in the financial industry and Chile's development as an exporter of financial services. It introduces a series of changes as regards liquidity, financial innovation, competition and the integration of Chile's capital markets. In particular, it creates a standard loan to make it easier for potential borrowers to compare different alternatives and ensures free competition in the sale of insurance related to financial products. In addition, it opens up new financing options.

The initiative seeks to give a new boost to the development of Chile's financial markets, encouraging competition between the different players and extending the range of instruments available. It also seeks to position Chile as a regional financial centre, making use of its comparative advantages in areas that include its institutional framework, economic stability and experience in the management of financial assets.

The bill is structured around four broad objectives: a) to increase the liquidity and depth of the country's capital markets; b) to expand the financial market so as to ensure that a larger universe of agents have access to the bank and non-bank financial system; c) to introduce new elements of competition in the credit market; and, d) to facilitate the financial integration of Chile's capital markets.

In its design, the bill benefited from the valuable opinions expressed by all the players in Chile's financial industry. Represented by the Capital Markets Consultative Committee, they contributed to the development and analysis of many of the reform proposals considered in this bill as in previous initiatives.

In contrast to previous capital markets reforms, MKIII comprises a series of legal measures as well as 14 administrative measures of which 11 are already in force. Similarly, some of the legal measures that were initially announced as an integral part of this agenda in August 2008 have already been implemented through special legal initiatives. This is the case, for example, of some modifications on securitisation and exemption from capital gains tax from fixed-income instruments. These measures, contained in Law N° 20.343 (Pro-Credit Agenda), are in force.

Terms of the bill

I. Credit market competition and consumer protection

The bill seeks to increase competition in the credit market both by expanding the range of instruments available and the supply of credit and by creating the conditions in which consumers can adopt decisions freely on the basis of information that permits comparison.

Standardisation of basic loans. In order to ensure that individuals can compare different financial alternatives, institutions that are authorised by law to provide mortgages, consumer loans and credit cards will have to offer at least one basic product with standardised characteristics and clearly

visible costs, thereby facilitating the task of finding and selecting the best alternative. The nature of this basic loan will be regulated under norms issued by the Finance and Economy Ministries after consultation with the Superintendencies of Banks and Financial Institutions (SBIF), Social Security (SSS) and Securities and Insurance (SVS).

Protection of freedom of insurance purchase. This measure is designed to safeguard borrowers' right to freedom in purchasing loan-related insurance. To this end, the bill stipulates that offers of loans to consumers must set out separately the cost of this insurance and guarantee the consumer's right to choose from whom to acquire it.

New mortgage bonds. The bill authorises banks to issue long-term bank debt instruments, known as mortgage bonds, exclusively for the purpose of financing loans with a mortgage guarantee. The issuing bank may periodically place bonds of this type on the market, raising finance for its expected issue of mortgages. This reduces the cost of financing mortgages by giving the issuers access to cheaper long-term funding while allowing investors to acquire instruments with a lower risk since, in the case of a bank's insolvency, the pool of underlying bonds can be offered to other banks.

Offer of credit by overseas bank representative offices. In Chile, there are 30 representative offices of overseas banks which, until now, have been permitted only to act as intermediaries for loans to local companies from their headquarters abroad. Under the bill, these players will be able to publicly offer the products they offer abroad in Chile, increasing competition in the local market and making the loans for which serve as intermediaries available to new clients.

II. Market liquidity and depth

The bill modifies the regulatory and tax framework for the mutual and investment fund industries in a bid to foster the development of new instruments, expand the universe of investors and allow these funds greater flexibility and liquidity as investment vehicles.

Greater flexibility for investment funds. The bill authorises the issue of investment fund shares that permit premature redemption and the creation of a mechanism other than a shareholders' meeting for approving capital increases and decreases, providing both these options are expressly stated in the fund's internal regulation. It also authorises investment funds to issue series of shares, allowing them to target different investors in line with their differing characteristics and risk profiles.

New investment instrument. The bill authorises the development of Exchange Traded Funds (ETFs) in Chile whose shares are traded in the stock market. Therefore, they can be used to reproduce the yield on stock market indicators with a high degree of accuracy and can be bought and sold freely at different prices during the day. Chile's private pension funds (AFPs) will be able to invest in this asset class under conditions and requirements established in each fund's investment policy. Subscriptions and redemptions in the form of securities in EFTs will be tax-neutral.

Access to secondary markets. The bill allows shares in mutual funds to be traded in formal secondary markets and to be subscribed and redeemed not only in money but also in securities that reproduce the fund's portfolio.

More expedite administrative procedures. The process for approving the internal regulation of mutual funds and contracts for subscribing shares will be assimilated to that that currently exists for insurance policies, allowing these documents to be deposited in a special register held for this purpose by the Superintendency of Securities and Insurance (SVS). This will make these procedures faster while still maintaining proper rigour in their review by the regulator.

Incentives for investors in mutual and investment funds. Under current tax law, capital gains obtained from the sale of a series of assets are exempt from income tax on the capital gains obtained in selling them. Under MKI, approved in 2001, these exemptions include liquid company shares, liquid investment fund shares and the redemption of shares in mutual funds that invest in liquid company shares. Subsequently, as from May 2009 with the approval of Law N° 20.343 containing the Pro-Credit Initiative, this exemption was also extended to some debt instruments.

However, since the present bill will modify various aspects of the regulation of both mutual and investment funds, it is necessary to reflect these changes in the design of the tax benefit established by law for capital gains resulting from the sale or redemption of shares in both types of funds.

a) In the case of funds that invest in liquid securities, the bill extends the exemption to those funds that hold at least 90% of their portfolio in liquid securities and debt instruments authorised under the Pro-Credit Initiative.

b) Shares in mutual and investment funds that are widely traded on the formal secondary market will be entitled to this exemption when sold or redeemed, providing they fulfil three conditions: the fund is invested in instruments that generate interest or dividends; all these flows are automatically distributed upon receipt to the fund's investors; and, some special conditions are respected as regards the securities in which the fund invests, both in Chile and abroad.

c) In the case of the sale of company shares, shares in funds or other similar instruments with a right to dividends or any type of flows prior to receipt of that payment, the management company will have to distribute an amount equivalent to the total of these dividends or flows to the fund's investors. Those investors, who sell liquid company shares or liquid shares in investment funds between the declaration of dividends and the date of closure of the list of those with a right to receive payment, will be liable to be taxed on the part corresponding to the dividend declared, despite their exit.

III. Expansion of financial market

The bill seeks to expand access to the financial market in order to ensure that a larger universe of individuals and companies can obtain financing through the bank and non-bank system.

A new boost for securitisation. The bill modifies regulation of securitisation in a bid to make this financing alternative accessible to smaller companies and start-ups. For this purpose, it permits subscription of lines of securitised bonds, reducing the transaction costs of this form of financing and making the instruments issued more flexible.

More flexibility for venture capital funds. The bill reduces from 50 to 25 the number of investors required for a fund to be considered public and be entitled to tax benefits. It also introduces more flexibility as regards a venture capital fund's exit from companies in which it invests in terms of minimum portfolio diversification (no more than 40% of the fund in a single project).

Improvements for overseas venture capital funds. The bill modifies the legal framework for these funds, reducing from five to three years the period before the capital contributed to the fund can be repatriated and allowing them to take on debt.

IV. International integration

The bill seeks to facilitate the financial integration of Chile's capital markets by introducing various incentives for foreigners to tap into the advantages of investing in Chile or carrying out financial transactions with the rest of the world from Chile.

Internationalisation of the peso. The Offshore Stock Market, which currently operates only in foreign currencies authorised by the Central Bank, will also be able to trade securities in pesos. For this purpose, the bill will allow overseas securities or their certificates of deposit offered in Chile to be expressed in pesos, even though they are traded and paid in a foreign currency. They will also be able to be denominated, traded and paid in pesos under conditions and requirements established by the Central Bank.

Incentives for institutional investors. At present, foreign institutional investors who comply with certain conditions can claim exemption from income tax on capital gains arising from liquid shares and bonds. The bill broadens the range of domestic financial instruments that can be acquired by this special category of overseas investors using this tax exemption, adding shares in mutual and investment funds established in Chile to liquid shares and bonds.

In the case of funds with liquid shares, all foreign investors, not just institutional investors, will be exempt from tax on flows arising from investments with an overseas source.

Limits on hiring foreigners. In order to encourage globalised investment management companies and those offering complementary services to set up operations in Chile, they will, in the case of specialised technical staff, be exempt from the obligation that at least 85% of their employees be Chilean.