THE WORLD BANK GROUP

CHILE

FINANCIAL SECTOR ASSESSMENT

December 2021

TECHNICAL NOTE

HOUSEHOLD INDEBTEDNESS AND FINANCIAL CONSUMER PROTECTION

Prepared By
Finance, Competitiveness, and Innovation Global Practice, WBG

This Technical Note was prepared in the context of a joint IMF-World Bank Financial Sector Assessment (FSA) mission in Chile during August 2021 led by Charles Cohen, IMF and Miquel Dijkman, World Bank, and overseen by the Monetary and Capital Markets Department. IMF, and the Finance, Competitiveness, and Innovation Global Practice, World Bank Group. The note contains the technical analysis and detailed information underpinning the FSA's findings and recommendations. Further information on the FSA program can be found at www.worldbank.org/fsap.

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Glossary

BCCH	Banco Central de Chile (Central Bank of Chile)
CCAFs	Cajas de compensación y asignación familia (compensation funds)
CMF	Comisión para el Mercado Financiero (Financial Market Commission)
FinCoNet	International Financial Consumer Protection Organisation
FSA	Financial Sector Assessment
MoE	Ministry of Economy, Development and Tourism under that Law
MoF	Ministry of Finance
NPL	Non-performing loan
SERNAC	Servicio Nacional del Consumidor (National Consumer Service)

EXECUTIVE SUMMARY[1]

Prior to the COVID-19 pandemic, household indebtedness in Chile had been growing and some key indebtedness indicators were relatively high. For example, Chile was found to have the highest percentage of households with a financial burden (monthly repayments to monthly income) of at least 25% among similar countries as examined in research conducted by the authorities at the time. Chile's median financial burden was observed to reach above the 75th percentile in a sample of countries with similar levels of development if credit cards and lines of credit were taken into account. Non-performing consumer loans issued by non-bank credit providers, comprising credit card issuers and other institution types tending to serve consumers at lower income levels, appeared to grow significantly. Consumer over-indebtedness and other credit-related harms, particularly for lower income households, had emerged as a source of considerable concern for the Chilean authorities. Even if stability of individual institutions, or of the system as a whole, was not threatened, it was already seen as important from a policy perspective to mitigate the potential harm to affected consumers.

During the pandemic a majority of lower income households experienced a reduction in their income, affecting their ability to cover expenses and repayment obligations. More than 55% of households in the bottom two income quintiles saw their income reduced compared to pre-pandemic. At the end of 2020 more than half of households in Chile were receiving some type of benefit and 48% of families in the bottom quintile indicated not having sufficient income to cover their expenses.

The Chilean authorities and industry implemented various measures to address financial impacts of the pandemic on households, but such measures may also have masked some longer term indebtedness vulnerabilities, particularly for more vulnerable households. Measures such as temporary debt repayment deferrals and social transfers were introduced to assist households in dealing with shocks and limit potential debt defaults. A measure introduced during the pandemic with key implications for indebtedness was to allow Chileans to make multiple withdrawals from their pension fund holdings. Funds from these withdrawals were used to a significant extent to repay existing debt. In addition to the potential impact of early withdrawals on pension funds and the future wellbeing of citizens in retirement, these measures may have concealed weaknesses in the existing framework for prevention of individual over-indebtedness, which could manifest again as patterns of consumption and related uptake of consumer credit resume post-pandemic.

While the pandemic has seen a reduction in some indebtedness indicators, even with pandemic-related measures in place some indicators have remained materially high from a consumer protection perspective. For example, combined bank and non-bank consumer NPLs decreased to approximately 8% in 2020 from 10% the previous year and both mortgage and non-mortgage consumer credit uptake contracted. Nevertheless, while the percentage of debtors with a financial

[1] This Technical Note has been prepared by Gian Boeddu and Ivor Istuk (WBG).

burden that exceeded 50% decreased, over 15% of debtors in the lowest income decile, and 13% of those in the next lowest deciles, continued to face such a heavy burden.

Chile has made considerable progress in strengthening financial consumer protection regulation and supervision in relation to credit. A range of consumer protection measures have been introduced over the years, including with regard to credit disclosure and regulation of provider conduct, and increasing resourcing and expanding powers for supervisory authorities. For example, the Protection of Consumer Rights Law and related regulations have been amended several times to introduce various financial consumer requirements relevant to credit, including requiring provision of pre-contractual disclosure information to consumers and prohibiting unfair terms in consumer contracts.

Notwithstanding these valuable efforts, there remain financial consumer protection gaps and concerning industry practices that can contribute to consumer over-indebtedness and other credit-related hardship. A key gap until now has been lack of regulatory requirements for credit providers to conduct loan affordability and suitability assessments to mitigate risks of consumers being provided with unaffordable or unsuitable loans. To bridge this gap, very recent legislative amendments introduced a new general creditworthiness assessment obligation but to be effective the new obligation will need to be supported by sufficiently specific parameters in implementing regulations to be issued by the Ministry of Economy, Development and Tourism (MoE) and Ministry of Finance (MoF). The new obligation also does not include a focus on assessing suitability of credit for the borrower's circumstances.

Gaps and deficiencies in the credit information system also undermine the quality of creditworthiness assessments that providers can undertake. Current major sources of credit reporting information comprise two public credit registries administered by the financial sector regulator (CMF) and the Santiago Chamber of Commerce. The CMF registry holds only limited positive and negative credit information. While it provides a snapshot of a consumer's current credit liabilities in aggregate, it lacks historical information regarding prior loans, repayment history, and historical defaults. Access to the registry is available to only certain categories of credit providers. The second public registry is limited to certain types of negative credit data, mainly from mandatory reporting of dishonored checks by banks and some other unpaid financial and non-financial debts.

Various potentially problematic credit-related sales practices were also identified in the market. These include: credit providers incentivizing lending staff based on credit volumes without taking into account the quality of loans made; increasing emphasis on pre-approved credit offers and more aggressive credit sales and marketing; extensive bundling of credit protection insurance of potentially questionable value; and debt collection practices continuing to be identified as a major concern for consumers.

Some gaps and other issues affecting credit provider oversight may be limiting the ability of authorities to detect and address problematic industry practices of the kinds noted. The need for adequately resourced and effective oversight is becoming even more crucial given new and increased risks from digitalization, increasing complexity of products and the need to supervise an expanding range of products and market participants which will bring new financial consumer protection challenges for the authorities.

The table below summarizes recommendations, discussed in more detail later in this Technical Note, intended to assist the authorities to address identified financial consumer protection issues. Each recommendation indicates the page number at which a more detailed discussion can be found in the note.

Recommendations			
	Recommendations	**Responsible Authorities**[2]	**Time***
Require all credit providers to conduct appropriate credit affordability and suitability assessments before credit approval			
1	Introduce implementing regulations under the newly introduced creditworthiness assessment provision in the Protection of Consumer Rights Law that are sufficiently specific to ensure all credit providers[3] undertake an adequate assessment of a prospective borrower's ability to repay without hardship prior to entering into a loan or granting a credit increase. (¶ 25)	SERNAC/MoE (in coordination with CMF/MoF)	I
2	Expand coverage of credit reporting system to be more comprehensive and include positive, alternative, and historical data, and refrain from deleting negative credit information. (¶ 25)	CMF/MoF	NT
3	Introduce regulatory requirements to require a proportionate assessment of a proposed credit contract's suitability to meet a borrower's needs, requirements and objectives.[4] (¶ 25)	CMF/MoF, SERNAC/MoE	NT
4	Consider whether stronger anti-discrimination rules, or enforcement of existing rules, are needed to ensure that prospective consumers for credit are not being discriminated on an unfair basis (e.g. based on their ethnicity). (¶ 25)	SERNAC/MoE	NT
Introduce credit product design and distribution requirements for all credit providers			
5	Introduce requirements requiring all credit providers to have in place proportionate product design and governance arrangements designed to ensure that their credit products meet the needs of consumers in their target markets. (¶ 33)	CMF/MoF, SERNAC/MoE	NT

[2] With Congress as relevant where passage of/amendment to primary legislation is needed.

[3] References to 'all credit providers' in these recommendations refer to all entities engaging in the business of providing consumer credit in Chile, including those not prudentially regulated by CMF.

[4] As discussed later in the note, if the authorities proceed with the draft Financial Innovation Bill, the suitability requirements proposed in the Bill should apply consistently to all, and not only some, credit providers as is currently contemplated.

Recommendations			
	Recommendations	**Responsible Authorities[2]**	**Time***
Require all credit providers to mitigate risks of conflicted sales incentives, unsolicited credit offers and bundling of credit protection insurance			
6	Introduce targeted restrictions on unsolicited credit marketing, including via digital channels. (¶ 35)	CMF/MoF, SERNAC/MoE	NT
7	Introduce requirements imposing general conflicts of interest mitigation obligations on all credit providers as well as more specific regulatory requirements to address conflicted remuneration structures and sales incentives. (¶ 35)	CMF/MoF, SERNAC/MoE	NT
8	Remove the exception for credit protection insurance[5] from the new ratification requirement in the Commercial Code and strengthen the parameters of that requirement or, alternatively, implement credit protection insurance-specific requirements that more strictly target risks for bundled sales of such insurance, such as a deferred sales model. (¶ 38)	CMF/MoF	NT
9	Undertake a comprehensive thematic review of current industry sales practices for credit protection insurance, including regarding suitability of relevant insurance policies being sold to consumers. (¶ 38)	CMF/MoF, SERNAC/MoE	I
Prioritize supervision of recently strengthened debt collection requirements			
10	Focus supervision and enforcement efforts on debt collection practices and effective implementation of recently strengthened debt collection requirements. (¶ 42)	SERNAC and CMF	I
Introduce a comprehensive licensing framework for consumer credit			
11	Implement a licensing framework for all consumer credit providers on an activities-basis, to cover different kinds of providers and to adapt to new entrants. (¶ 43)	CMF/MoF, SERNAC/MoE	NT
Commission a comprehensive review of current supervisory and regulatory arrangements			
12	Commission a review (not limited to credit) of current financial consumer protection supervision institutional arrangements, resourcing, expertise and independence, processes and data infrastructure to confirm their appropriateness to address consumer issues long term. (¶ 46)	MoF and MoE	NT
* I (immediate) = within one year; NT (near term) = 1–3 years			

[5] Note: Credit protection insurance here refers to insurance that covers a borrower's ability to make repayments (in case of events such as of loss of employment, illness, disability or death).

A. Introduction

1. This Technical Note discusses household indebtedness issues in Chile from a financial consumer protection perspective. The note discusses over-indebtedness concerns and other credit-related issues practices that appear to be adversely affecting consumers – particularly more vulnerable, lower income consumers – in Chile and gaps in the current financial consumer protection regulatory and supervisory framework needing to be bridged to assist in addressing these issues. The note considers both issues that had already manifested prior to the COVID-19 pandemic and developments during the pandemic.

2. Importantly, the note highlights credit-related issues which warrant focus from a consumer protection perspective even if they may not necessarily be a concern from a stability perspective. Consumer over-indebtedness and other credit-related harms, particularly for lower income households, have emerged as a source of considerable concern in Chile. Even if stability of individual institutions, or of the system as a whole, was not threatened, it would be important from a policy perspective to also mitigate the potential harm to affected consumers. In recognition of this, the Chilean authorities requested that relevant financial consumer protection issues be considered as part of the current FSA.

3. Current practices and financial consumer protection arrangements and approaches in Chile are considered in light of international good practices and trends, while taking into account country context. The discussion in the note is based on primary and secondary country research completed in December 2021 and has had regard to a range of international materials and research referenced throughout including, for example, as produced by the World Bank Group, the International Financial Consumer Protection Organisation (FinCoNet - an international organization of financial consumer protection supervisory authorities) and the G20-OECD Financial Consumer Protection Task Force.

B. Household indebtedness in Chile

I. Prior to the pandemic indebtedness indicators had been increasing

4. Prior to the COVID-19 pandemic household indebtedness in Chile had been growing and the authorities identified that some key indebtedness indicators were high when compared to similar countries. As shown in Table 1 below, immediately prior to the pandemic Chile was observed to have the highest percentage (11.4%) of households with a financial burden ratio of at least 25% amongst countries considered.[6] While Chile's median financial burden to household income (monthly repayments to monthly income) of 14.0 was between the 50th and 75th percentile of a sample of countries with similar levels of development to Chile, it was observed to rise above the 75th percentile

[6] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 7-8. Also see BCCH, *Financial Stability Report – Second Half of 2019.* 2019.

if credit cards and lines of credit were included.[7] This type of credit was noted to be highly relevant in Chile compared to most of the countries in the sample.[8]

Table 1: International indebtedness indicators

(percentage, times)

		All countries (1)				Chile and countries with similar development indicators (2)			
	Chile	#Obs.	P25	P50	P75	#Obs.	P25	P50	P75
Households with debt	66.4	31	36.8	47.0	64.6	10	36.7	36.9	41.2
DTI (3)	3.0	30	5.1	9.5	14.3	9	3.0	5.0	6.4
Percentage of households DTI>36 (4)	2.6	28	3.9	8.8	14.2	9	2.6	3.8	4.4
FOR (5)	14.0 (20.7)	22	11.5	13.4	16.3	9	11.1	12.4	16.2
Percentage of households FOR>25% (4)	11.4 (27.7)	21	4.7	6.5	11.3	9	4.8	5.5	8.9

(1) Includes: Australia, Austria, Belgium, Canada, Chile, Cyprus, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Latvia, Luxemburg, Malta, Norway, New Zeeland, Netherlands, Poland, Portugal, Slovakia, Slovenia, South Korea, Spain, U.S., U.K., Uruguay. Data (2012-2015); Chile (2017).

(2) Includes Chile and countries in sample with GDP per capita below 30,000 USD.

(3) Median of the debt to gross monthly income ratio (times) of households with debt.

(4) Estimated over all households in each country.

(5) Median of the financial obligations (excl. credit cards and credit lines) over gross monthly income ratio (percentage) of households with debt. Data in parenthesis for Chile includes credit cards and credit lines.

Source: Reproduced (with translation) from: Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (CMF Working Document No.1/21). April 2021, Table 1.

5. The percentage of consumer loans that were non-performing had been growing in the last few years prior to the pandemic. According to data provided by the Chilean authorities, the overall percentage of consumer non-performing loans (NPLs) grew in the last few years prior to the pandemic, from 6.4% and 6.3% in 2016 and 2017 respectively, to 9.1% and then 10.1% in 2018 and 2019 respectively.[9]

6. Non-bank consumer NPLs grew significantly, itself of concern given that in Chile lower income borrowers tend to be served mainly by non-bank credit providers, such as retail credit card issuers. Bank consumer NPLs ranged from 5.9% to 6.6% during the 2016-2020 period. By

[7] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 7.

[8] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 8.

[9] Data provided by the Chilean financial sector authorities, September 2021.

contrast, consumer NPLs provided by non-bank credit providers appear to have increased significantly, from 3.6% in 2017 (the first year for which data was made available) to 13.6% in 2019 (with a drop once the pandemic began to 11.9% in 2020).[10] The authors of a recent Financial Market Commission (*Comisión para el Mercado Financiero* – CMF) paper highlighted, for example, that the highest level of defaults amongst different kinds of credit providers was observed for labor union compensation funds (*cajas de compensación y asignación familia* (CCAFs).[11]

7. Households in the bottom 50% of income levels that held non-bank credit card debts had significantly higher levels of such debt relative to their income than those with higher incomes. Households with consumer debt that were in the bottom 50% in terms of income level had the highest median ratio of monthly repayments (financial burden) debt to monthly income (27.4 vs around 23% for higher income levels),[12] even if their ratio of overall debt to income appears lower than that for higher income household. Relevant debt would seem to comprise mostly non-mortgage credit with shorter terms and higher rates than mortgage loans.[13]

Table 2: Household income and median debt

Income levels	Median income	Median amount of consumer credit debt	Ratio debt relative to median income	Median non-bank credit card debt	Ratio of non-bank credit card debt relative to median income
Bottom 50%	**CLP$476,117**	**CLP$547,705**	**1.150358**	**CLP$294,560**	0.618671461
Mid 30%	**CLP$1,236,223**	**CLP$1,319,660**	**1.067493486**	**CLP$301,110**	**0.243572559**
Top 20%	**CLP$2,937,733**	**CLP$3,687,318**	**1.255157633**	**CLP$596,667**	**0.203104571**

Source: Table based on median household income (Table 2.1) and median debt (Table 3.7) in BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 12-13 and 24-25.

8. A CMF Working Document also concluded (based on 2017 data) that applying the methodology proposed in the document 29% of Chilean households would be over-indebted, or 45% of households with debt. It explained that such over-indebtedness was strongly linked to a high monthly repayment burden vs income, which was classified as "short-term over-indebtedness", in contrast to a high total debt owed vs income comparison.[14] However, from a consumer protection perspective this could nevertheless be a long term issue for consumers in Chile, both if they are engaging in repeated borrowing at the same levels or are having to refinance (roll over) existing debt.

[10] Data provided by the Chilean financial sector authorities, September 2021.

[11] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 6.

[12] BCCH, Household Financial Survey 2017: Main Results. October 2017, 28-29.

[13] BCCH, Household Financial Survey 2017: Main Results. October 2017, 30.

[14] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 35.

9. Lower income borrowers can be impacted by hardship even if only small amounts of debt are involved. For example, a recent academic analysis of consumer debt for the first quarter of 2021 carried out in conjunction with one of the credit bureaus operating in Chile found that nearly half (47.1%) of loan defaults related to amounts of less than CLP$300,000.[15] Average default amounts in the lowest of five segments were CLP$52,688 and the next segment CLP$184,812, suggesting that consumers were going into default in relation to relatively small amounts.

10. Even if pre-pandemic indebtedness indicators were not necessarily a concern from a stability perspective, they suggested potential issues of concern from a financial consumer protection perspective. Analyzing indebtedness from a consumer protection perspective focuses on how particular cohorts of consumers are affected rather than broader indebtedness levels in the market. For example, the authors of a recent CMF paper observed that non-bank credit providers have higher levels of delinquencies than banks (with the highest delinquencies observed among CCAFs) but that this would not represent a threat to financial stability.[16] It may be the case that a cohort of consumers is provided with loans that they cannot afford and which may thus lead to hardship or defaults, while the aggregate lending or number of borrowers involved is nevertheless insufficient to have adverse implications for individual institutions or the sector from a stability perspective. One expert commentator expressed the view that, while higher overall levels of indebtedness in Chile could be explained in the context of financial deepening, a segment of the public was indebted beyond their means. While such borrowers may make significant efforts to repay, including through repeated refinancing, and pay a significant amount of interest along the way, they may ultimately be unable to do so while suffering corresponding hardship.

II. The impact of the pandemic and temporary interventions

11. A majority of lower income households experienced a reduction in their income during the Covid-19 pandemic affecting their ability to cover existing expenses. BCCH reported that during the pandemic more than 55% of households in the bottom two income quintiles saw their income reduced compared to pre-pandemic, this number dropping to a still significant 37% for the highest quintile. At the end of 2020 more than half of households in Chile were receiving some type of benefit and 31% declared not having sufficient income to cover their expenses, rising to 48% of families for those in the bottom quintile.[17]

12. A consumer survey conducted by SERNAC in 2020 indicated significant pandemic-related negative impacts on indebted consumers. 55% of respondents said they had difficulty repaying their debts during the pandemic, 36% indicating this was due to income reductions from the pandemic and 24% indicating higher commitments to support family and friends. More than half of

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[15] St. Sebastian University, *XXXII Delinquent Debt Report.* May 2021. https://resources.uss.cl/upload/2021/05/XXXII-Informe-Deuda-Morosa-1-Trimestre-2021.pdf 11.

[16] Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 6.

[17] BCCH, *Financial Stability Report – First Half of 2021.* 2021, 33-34.

the consumers surveyed have had problems paying their debts in the context of the pandemic. Almost 80% of respondents reported feeling harassed by debt collection actions. 34% believed they would not be able to repay their debts while the current economic situation continued and 11% thought they would become more indebted.[18]

13. The Chilean authorities and industry implemented various measures to address the impact of the pandemic but these may also have masked some longer term indebtedness vulnerabilities. Measures such as payment deferrals (and temporary provisions introduced for CMF-regulated credit providers to facilitate such deferrals), and social transfers were introduced to assist households in dealing with shocks and limit potential defaults. During 2020 credit providers implemented various repayment rescheduling arrangements for both mortgage and non-mortgage credit, including for products such as credit cards. Between March and August 2020 1,929,159 such arrangements were reported to the authorities.[19]

14. A measure with key implications for indebtedness was to allow Chileans to withdraw a part of their pension fund holdings which were used to a significant extent to repay existing debt. Since July 2020, pension fund holders have been allowed to make three withdrawals, each of up to 10% of their holdings. BCCH estimates that 62% of withdrawals went to pay down debt or were transferred to other forms of savings. Anecdotal indications during meetings with industry participants, commentators and authorities were also that, while a portion of these withdrawals was spent on consumption, a material portion was used to repay existing debt. For example, multiple banks were of the view that a drop in their NPLs from 4%-5% to less than 2% during the pandemic was due to a significant extent to Covid-related measures, including pension fund withdrawals. One bank described their NPL numbers as being 'distorted' by pandemic-related measures. They were currently around 1.8% but had been around 5.8% pre-pandemic and they expected NPLs to increase once relevant measures lifted.

15. At least in part due to these measures, during the pandemic there has been a reduction in some indebtedness indicators. For example, combined bank and non-bank consumer NPLs dropped to 8.2% in 2020 from 10.1% the previous year.[20] Both mortgage and non-mortgage consumer credit contracted, with consumer credit demand showing the greatest contraction. BCCH observed that crisis-driven adjustments that consumers made to their balance sheets and their consumption patterns led to a lower demand for credit.[21] While 2020 saw a marked drop in the total number of consumer loans reported to the authorities – down to 15,362,698 from a high of 18,337,083 in 2019 – the total value of such loans remained at a similar level to 2019, CLP$82,635,270, indicating that average loan balances of outstanding loans grew.[22] The total number of consumers with active

[18] SERNAC, *55% of Consumers Admit They Have Difficulty Paying Their Debts Due to the Pandemic*. September 2020. https://www.sernac.cl/portal/604/w3-article-59226.html

[19] BCCH, *Financial Stability Report – First Half of 2021*. 2021, 45.

[20] Data provided by the Chilean financial sector authorities, September 2021.

[21] BCCH, *Financial Stability Report – First Half of 2021*. 2021, 32.

[22] Data provided by the Chilean financial sector authorities, September 2021.

loans dropped by around half a million.[23] However, while 2020 saw a marked drop in the total number of consumer loans reported to the authorities – down to 15,362,698 from a high of 18,337,083 in 2019 – the total value of such loans remained at a similar level to 2019, CLP$82,635,270, indicating that average loan balances of outstanding loans grew.[24] BCCH noted that there has been a reduction in deferrals of debts since mid-2020 as well as in the percentage of households reporting an inability to cover expenses. There also appear to be improvements in indebtedness indicators particularly for salaried bank debtors.[25]

16. However, while measures introduced by the authorities may have been appropriate and necessary in the context of the pandemic, for some consumers they may also have temporarily hidden longer term indebtedness vulnerabilities. In addition to the potential impact of early withdrawals on pension funds and the future wellbeing of citizens in retirement (which goes beyond the coverage of this note), such practices may be concealing weaknesses in the existing framework for prevention of individual over-indebtedness. As patterns of consumption and related uptake of consumer credit resume post-pandemic, relevant consumer protection weaknesses discussed in this note could once again lead to increases in over-indebtedness issues. BCCH noted that some of the reduction in defaults resulting from rescheduling during 2020 could be reversed in the upcoming period. It observed, for example, that prior instances involving loan rescheduling were followed by a rebounding increase in default rates as temporarily postponed debt, which had grown, became due without income keeping pace.[26] CMF has indicated they have not seen such a trend yet, although this may also depend on the continued effect of other fiscal aid.

17. Even with pandemic-related measures in place, some indicators have remained materially high from a consumer protection perspective. As shown in Figure 1A below, in 2020 CMF reported that 16% of debtors had a financial burden (the proportion of monthly income going to monthly repayments) that exceeded 50% as at June 2020. This represented a reduction from the figure of 18.8% reported a year earlier, immediately prior to the pandemic. 23.4% of debtors had a financial burden greater than 40% of their income, a similar figure to that reported in the previous year.[27] The figures as at June 2021 reported by CMF (see Figure 1B below) remained very similar, with 15.5% of debtors reported to have a financial burden exceeding 50% and 22.5% of debtors a financial burden exceeding 40%.[28] The financial burden measure, even more so than the leverage measure (the total debt owing vs monthly income) also discussed in the report, is particularly useful in considering potential consumer protection issues associated with lending, such as shortcomings in affordability assessments or the impact of debt collection practices on consumers that may result from defaults due to unaffordable lending.

[23] Data provided by the Chilean financial sector authorities, September 2021.

[24] Data provided by the Chilean financial sector authorities, September 2021.

[25] BCCH, Financial Stability Report – First Half of 2021. 2021, 33-34.

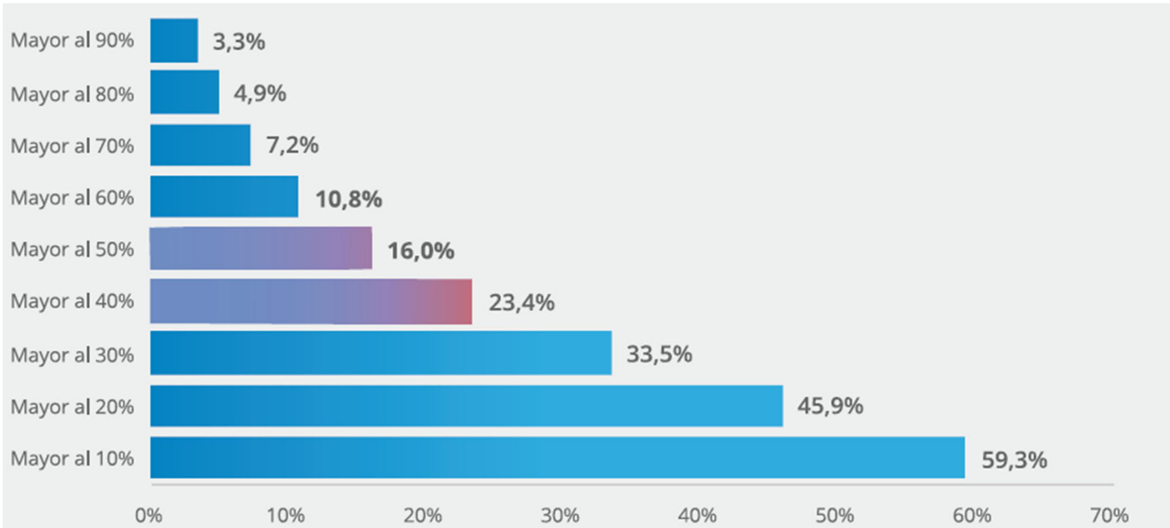
[26] BCCH, Financial Stability Report – First Half of 2021. 2021, 22, 32 and 35.

[27] Financial Market Commission, *Annual Report on Indebtedness – 2020.* December 2020, 12.

[28] Financial Market Commission, *Annual Report on Indebtedness – 2021.* December 2021, 13.

Figure 1A: Financial burden levels mid-2020

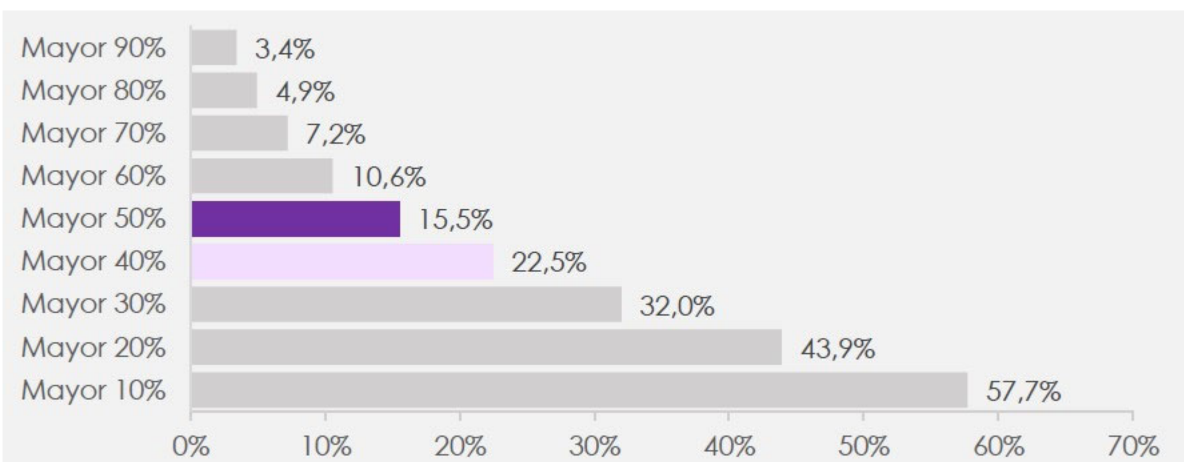
(percentage of debtors with a financial burden greater than each threshold shown)



Source: Reproduced as originally appearing in: Financial Market Commission, Annual Report on Indebtedness – 2020. December 2020. Graph R.1.1.

Figure 2B: Financial burden levels mid-2021

(percentage of debtors with a financial burden greater than each threshold shown)



Source: Reproduced as originally appearing in: Financial Market Commission, Annual Report on Indebtedness – 2021. December 2021. Graph R.1.1.

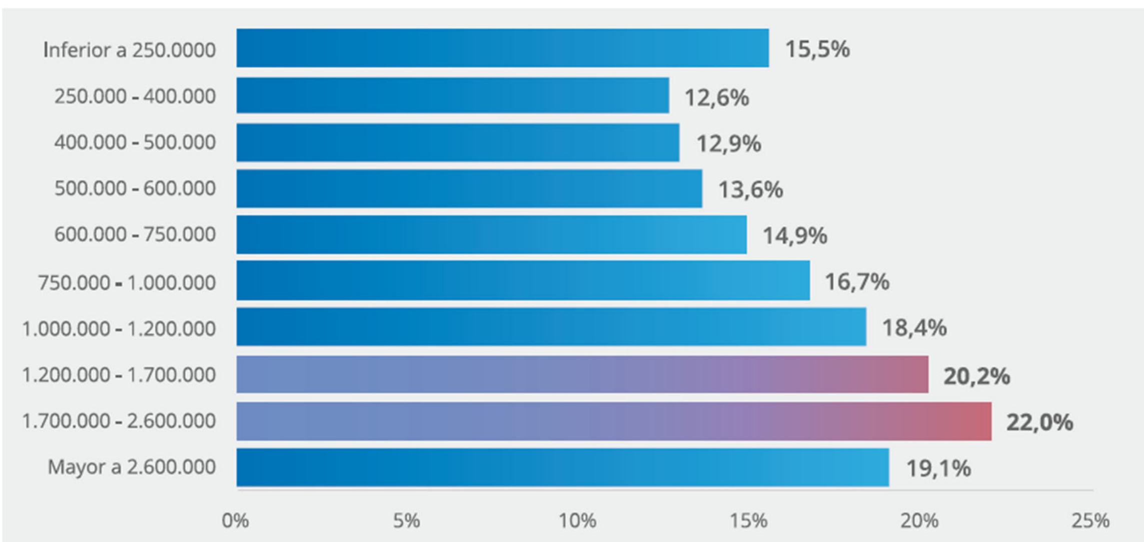
18. A high proportion of lower income debtors have a significant financial burden. In mid-2020 15.5% of debtors in the lowest income decile had a financial burden exceeding 50% as did 12.6% and 12.9% respectively of those in the next lowest deciles (see Figure 2A below).[29] In mid-2021 the

[29] Financial Market Commission, *Annual Report on Indebtedness – 2020.* December 2020, 12.

financial burden levels reported for the lowest decile was essentially the same (15.43%) with a small improvement in the level for reported for the next decile (10.96%).[30] Notably, when considered in real terms rather than only percentage terms the amount of remaining income, after accounting for repayments, available to debtors in these lower deciles would be much less. This is consistent for example, with the finding in a recent CMF Working Document analyzing sustainable indebtedness levels in Chile that for non-mortgage consumer credit borrowers on the lowest income level the sustainable indebtedness threshold could be as low as less than 5%, in contrast to a much greater 35% or over for those on high incomes. As noted in that paper, this was reflective of the fact that the higher the debtor's income, the greater the possibility of allocating a greater fraction of income to repayments.[31] CMF's latest annual report on household indebtedness also identified that bank debtors in the lowest two income deciles had the highest ratio of overdue bank debt (an equivalent analysis was not included for non-bank debts), with approximately 8.5% of debt held by those in the lowest decile at least 60 days overdue, and approximately 8% of debt held by those in the next lowest decile similarly at least 60 days overdue. The ratio of unpaid debt to total debt decreased as income increased.[32] The report also identified that

Figure 3A: Financial burden greater than 50% of income by income segment - 2020

(percentage of debtors in each segment)



Source: Reproduced as originally appearing in: Financial Market Commission, Annual Report on Indebtedness – 2020. December 2020. Graph R.1.2.

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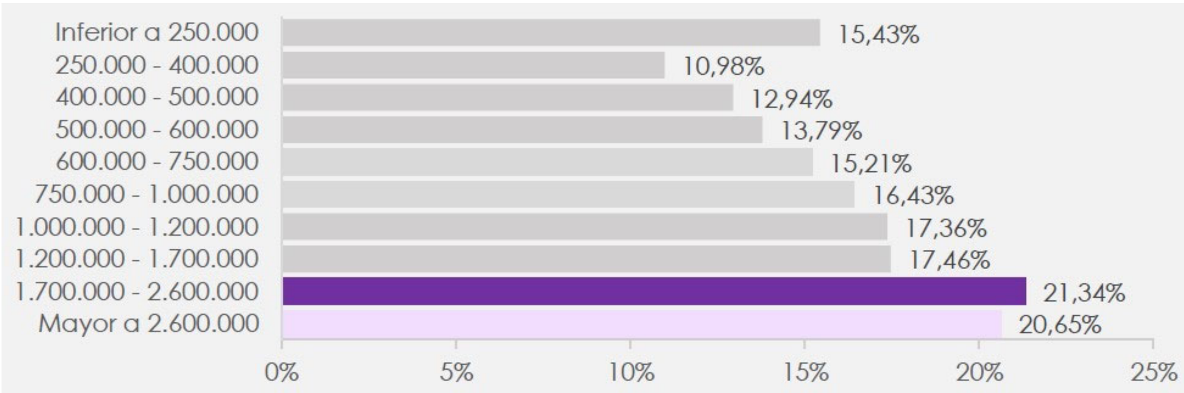
30 Financial Market Commission, *Annual Report on Indebtedness – 2021.* December 2021, 13.

31 Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 27-28.

32 Financial Market Commission, *Annual Report on Indebtedness – 2021.* December 2021, 17.

Figure 4B: Financial burden greater than 50% of income by income segment - 2021

(percentage of debtors in each segment)



Source: Reproduced as originally appearing in: Financial Market Commission, Annual Report on Indebtedness – 2021. December 2021. Graph R.1.2.

C. The consumer credit market in Chile

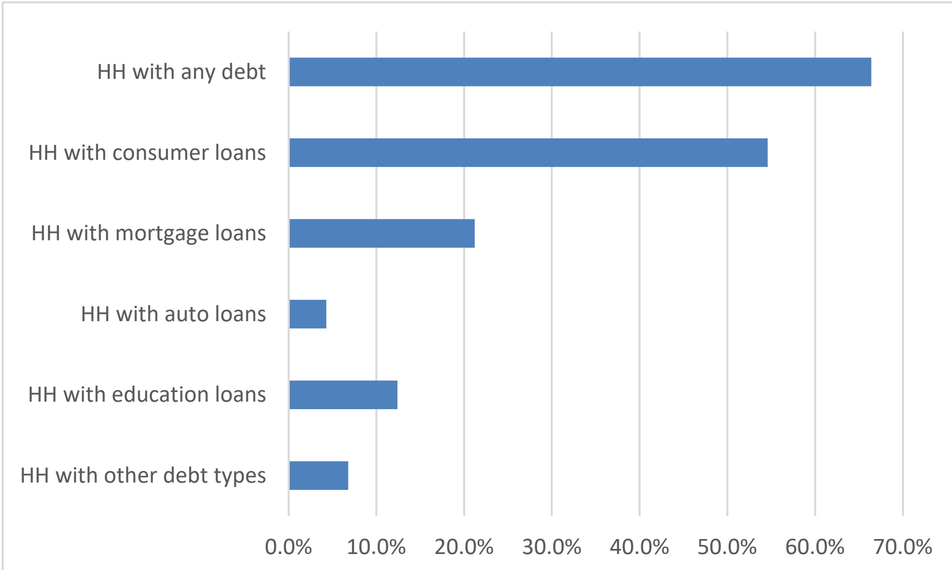
I. Product holdings

19. In a recent pre-pandemic report BCCH noted that holdings of lines of credit and credit cards by Chilean households were higher than the median of countries in the relevant sample. While mortgage credit holdings were below the median, a relatively high percentage of households nevertheless had obtained mortgage credit.[33] The last national Household Financial Survey indicated that 66.4% of households held debt of some kind. 54.6% of households held consumer loans (comprising bank consumer loans, credit cards and lines of credit, as well as consumer loans and credit cards provided by various non-bank lenders, including finance companies, CCAFs , credit unions and other types of businesses) with 4.3% of households holding auto loans and quite a significant 12.4% of households indicating they held education-related debts. 21.2% of households held mortgage loans (see Figure 3).[34]

[33] BCCH, *Finance System in Chile: Lessons from Recent History* (Economic Policy Document N. 67). October 2019, 11.

[34] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 16-17.

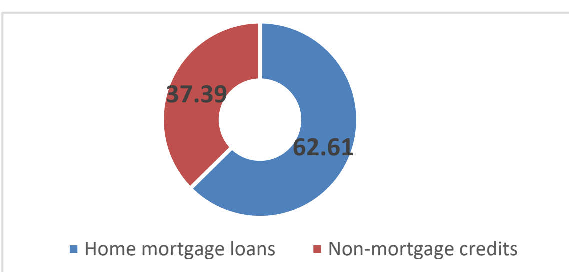
Figure 5: Percentage of households (HH) with debt



Source: Based on data in BCCH, Household Financial Survey 2017: Main Results. October 2017, 17.

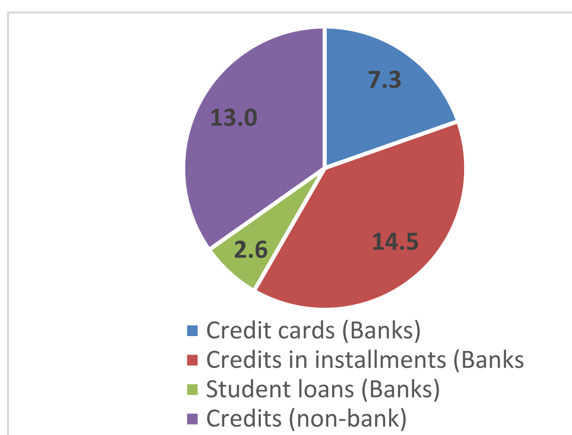
20. One third of the total amount of household debt comprises non-mortgage credit. Recent data shared by the authorities (see Figures 4 and 5) indicates that slightly under two thirds of the total amount of household debt comprised mortgage loans, while slightly one third presents non-mortgage credit.[35] Of the approximately one third of overall household credit comprising non-mortgage credit, bank instalment loans represented 14.5% and bank credit cards 7.3%, with 13% being credit from non-bank providers.

Figure 6: Household debt by product category (percentage of total) - preliminary data as at March 2021



Source: CMF and BCCH

Figure 7: Non-mortgage loans by product type (percentage of total household credit) - preliminary data as at March 2021



Source: CMF and BCCH

[35] Data provided by the Chilean financial sector authorities, September 2021.

II. Reasons for acquiring consumer credit

21. Consumers' purposes for obtaining non-mortgage consumer credit comprised a range of consumption purposes as well as debt refinancing. In the 2017 Household Financial Survey households with consumer credit indicated the top four purposes for acquiring such credit comprised financing the purchase of durable household items (18.8% of households), repaying existing debts (13%), purchasing non-durable consumer goods (11%) and purchasing clothing (10.5%). Focusing specifically on consumer credit products comprising bank-issued credit cards and lines of credit, and credit cards and other consumer credit provided by non-bank providers (excluding credit unions and CCAFs) the survey found the top three motivations for obtaining such credit comprised purchasing durable household items (28%), purchasing clothing (17%) and purchasing non-durable consumer goods (15%).[36] While only 4.3% of participating households indicated they held auto loans, it was noted in the survey report that this low percentage is in part likely due to consumers obtaining other types of credit products for the purpose of acquiring vehicles.[37]

22. Notably, if consumer credit purposes were weighted by amount of debt, the survey highlighted that one of the two main purposes for households acquiring non-mortgage credit was refinancing of existing debt.[38] A different survey in a similar period had indicated that 38% of participants that had obtained a consumer loan had done so for the purpose of repaying an existing loan.[39] Such significant levels of refinancing, particularly for non-mortgage credit, could be an indicator that the original credit being refinanced was unaffordable or consumers were seeking to avoid going into repayment default. Interestingly, data also suggests that Chilean consumers are on average acquiring a larger number of loans. Average number of loans held per consumer grew from 2.11 in 2017 to 2.61 in 2019 (dropping to 2.38 once entering the pandemic in 2020).[40]

III. Credit providers

23. The Chilean consumer credit market comprises a range of bank and non-bank credit providers but low-income consumers are now primarily served by non-bank participants. Consumer credit providers in Chile include banks, retail store credit providers (*casa comerciales*, some of which are bank-owned and others which are not), credit and savings unions/cooperatives (*cooperativas de ahorro y crédito*), CCAFs, and a variety of more specialized lenders such as auto

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[36] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 30-33.

[37] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 26.

[38] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 30-32.

[39] Statista, *Most Frequent Uses for Consumer Loans in Chile.* October 2017. https://www.statista.com/statistics/952875/common-uses-consumer-loans-chile/.

[40] Data provided by the Chilean financial sector authorities, September 2021.

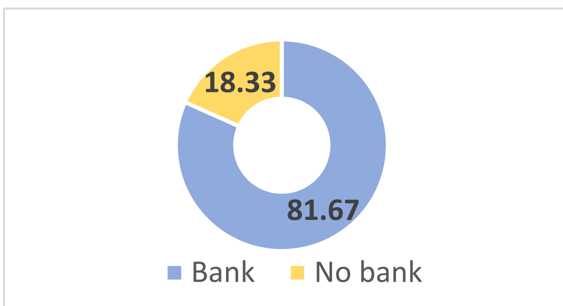
finance companies and education loan providers, leasing companies, insurance companies providing loans and pawn shops.[41]

Banks

24. Banks hold the majority of household debt by volume (see Figure 6 below)[42] but are primarily focused on offering credit to mid-level and higher level income consumers. Several banks confirmed in interviews that they target the middle income segment (with an income of at least CLP$1 million per month) with one bank explaining that none of the banks' commercial strategies target low income consumers, particularly those with monthly income of less than CLP$450,000.

25. Lower levels of credit information available about low income consumers combined with increasing levels of regulation such as interest rate caps have seemingly caused banks to move away from this segment. Participants suggested in discussions that due to these factors the lower income segment represents higher risk for lower returns making this market less attractive for banks, in contrast to non-bank providers that are more willing to accept such risk. (The development in Chile of measures such as interest rate caps is discussed in more detail in the separate FSA Technical Notes on competition and digital financial inclusion in Chile's financial sector).[43]

Figure 8: Household debt by type of financial institution (preliminary data as at March 2021)



Source: CMF and BCCH

Non-bank credit providers

26. Non-bank lenders (including some now owned by banks, as discussed below) have become a particularly significant source of credit for lower income consumers in Chile and are thus a key area of focus from a financial consumer protection perspective. Only 16.3% of households in the bottom 50% in terms of income level held consumer credit with banks,

[41] Madeira, C., *Adverse selection, loan access and default in the Chilean Market* (BCCH Working Paper N. 838). September 2019, 3 and 6. Pulgar, C., et al. *Maximum Sustainable Household Indebtedness* (Finance Market Commission Working Document No.1/21). April 2021, 5.

[42] Data provided by the Chilean financial sector authorities, September 2021.

[43] See separate Technical Notes produced for the FSA titled 'Competition in the Financial Sector' and 'Digital Financial Inclusion'.

significantly less than households in the next three income deciles (33%) and top two deciles (54.4%).[44] On the other hand, 36.7% of households in the bottom 50% held consumer credit with non-bank providers (excluding credit unions and CCAFs), comprising mainly holders of retail credit card accounts. 12.7% also held consumer credit provided by credit unions and CCAFs and similar entities. These were similar levels than those for households with higher income levels. A greater percentage of households with lower education levels held non-bank consumer credit.[45] The Central Bank of Chile (*Banco Central de Chile* - BCCH) highlighted potential risk that could arise from any inadequate regulation and supervision of this sector, as well as from the absence of a consolidated debt registry that covered the sector.[46] As discussed below, there is apparently also a growing so-called 'informal' lending sector offering credit particularly to more vulnerable, lowest income, consumers , although there is very limited information available regarding its size and composition. While fintech consumer credit providers do not yet appear to constitute a large part of the market, the Chilean fintech sector is expanding rapidly[47] and it is important that financial consumer protection keeps pace.

<u>Retail store credit providers</u>

27. Retail store finance (mainly through store credit cards) has been a significant driver of consumer credit in Chile, particularly at the lower income end of the market. As noted by BCCH, the development of the retail store credit market has been supported by a variety of market factors, including stores' ability to leverage strong retail brands being associated with credit offered as well as their own privately held databases of customers.[48]

28. Retailer credit cards were initially offered in Chile as a way to facilitate instalment credit for use exclusively at the retailer's physical stores, although some offerings have evolved into more general use credit cards.[49] For example, a department store credit card issued by a bank-owned provider, initially offered for use only in that store, was converted to a broader use Visa or Mastercard account, even if incentives remain for use of the card in the affiliated store.

29. In recent years there have been various acquisitions of retailer credit card businesses by banks, which have typically been transferred to bank subsidiaries. For example, in 2014-2015 one of the largest retailers in Chile sold its entire credit card portfolio and card origination business to a bank, involving 1.8 million credit card accounts that were transferred to a subsidiary of the bank.[50] The

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[44] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 23-24.

[45] BCCH, *Household Financial Survey 2017: Main Results*. October 2017, 24.

[46] BCCH, *Finance System in Chile: Lessons from Recent History* (Economic Policy Document N. 67). October 2019, 35-36.

[47] As discussed, for example, in the separate Technical Notes for the FSA titled 'Competition in the Financial Sector' and 'Digital Financial Inclusion'.

[48] Madeira, C., *Adverse selection, loan access and default in the Chilean Market* (BCCH Working Paper N. 838). September 2019, 6.

[49] Foley, F., et al. *The Effects of Information on Credit Market Competition: Evidence from Credit Cards* (Financial Markets Commission Working Paper No. 04/19). September 2019, 3.

[50] Foley, F., et al. *The Effects of Information on Credit Market Competition: Evidence from Credit Cards* (Financial Markets Commission Working Paper No. 04/19). September 2019, 3-4 and 9.

cards continued to be co-branded by the retailer, who also remained as the main originator for new cards.[51] The co-branded card was retained as a separate product from the acquiring bank's pre-existing cards.[52] BCCH noted that, in practical terms, such acquisitions by banks also resulted in the acquired businesses being able to bridge some of the informational gaps they had faced in credit reporting arrangements, as discussed later.

30. Closed loop retail store credit cards remain widely available, including offerings targeted at low income consumers. For example, one non-bank credit provider with a significant presence in retail malls offers a closed loop, non-revolving (instalments-only) credit card that can be used at their stores. The target market for this offering was said to comprise lower income customers and immigrants. Other participants similarly confirmed that non-bank credit card offerings tended to target mid to low income consumers.

31. Both bank and non-bank owned retail credit card providers offer on-the-spot approval for retailer-affiliated cards in retail stores. They typically offer incentives for card uptake and continued use, such as discounts on goods purchased in those stores using the cards. Such providers and their affiliated merchants capture and leverage customer store retail data for application assessments and credit promotions.

Credit and savings unions

32. The largest group of non-bank credit providers in terms of assets are credit and savings unions (credit unions for short). There are more than 40 credit unions in Chile but the sector is highly concentrated, with the largest credit union (COOPEUCH) being larger than 7 of the 18 banks in Chile. Small value consumer loans make up the largest portion of their credit portfolios, in large part comprised of payroll loans made to public sector employees.

CCAFs

33. Chilean employers are required to register their employees with one of a range of labor union-run CCAFs which provide so called social credit and other services to their clients. An employer selects the CCAF for their employees and these funds are required to offer services on the same conditions to all of their clients and are not permitted to discriminate based on the characteristics of individual debtors. CCAFs are private, non-profit entities created by law[53] that administer social security benefits but also grant so-called 'social credit'. Social credit is comparable to consumer credit but is subject to an aggregate 25% cap on salary deductions, with CCAFs deducting loan payments directly from their employers' payrolls, mitigating risk of default. In the event of a debtor losing their job, a CCAF may deduct amounts owed from the workers' severance payment,

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[51] Foley, F., et al. *The Effects of Information on Credit Market Competition: Evidence from Credit Cards* (Financial Markets Commission Working Paper No. 04/19). September 2019, 9.

[52] Foley, F., et al. *The Effects of Information on Credit Market Competition: Evidence from Credit Cards* (Financial Markets Commission Working Paper No. 04/19). September 2019, 20.

[53] See Law on the Establishment of Compensation Funds (Law 18,833 of 1989) Article 6

further reducing their risk.[54] Social credit has been extended to more than 1 million borrowers, mostly from lower income segments.

Leasing and auto finance providers

34. There are estimated to be at least 10 companies specializing in providing auto finance. The exact number of auto finance companies is unknown as those not owned by banks are not regulated by CMF or subject to any other credit licensing regime. Auto finance companies compete with other credit providers that offer credit for the purposes of acquiring motor vehicles, although banks tend to offer auto finance through subsidiaries. Auto finance providers often have preferential arrangements with auto dealerships, allowing representatives to offer consumers finance at dealership premises.

'Informal' lenders and developments in lending to low income consumers

35. A range of industry participants and commentators observed an increase in lending by 'informal' lenders, particularly targeting lower income and more vulnerable consumers. By informal lenders they appeared to be referring to lenders that are neither covered by the mandate of the prudential and market conduct regulator, CMF, nor being supervised in practice by the general consumer protection supervisory and enforcement authority, SERNAC (which is responsible for enforcement of consumer protection requirements applying to all consumer credit under Chile's Protection of Consumer Rights Law).[55] They indicated that they had noticed informal lenders offering credit significantly outside regulatory limits, such as fees and interests reaching several hundred percent annually (e.g. interest rates of 20% to 50% per month were mentioned), and some said they had reported these to SERNAC. Such informal loan offerings were said to be offered online and even advertised on radio and television. Participants believed informal credit is a growing trend in Chile, especially among immigrant and low income communities. Participants thought there was lack of clarity regarding SERNAC's capacity to monitor the market and had not seen detailed follow up regarding rogue lending activities. SERNAC itself acknowledged the informal credit sector is mostly out of their purview in practical terms given there are no requirements for credit providers to register with them.

36. It is difficult to assess the scope of the informal lending sector given the current lack of available data regarding its make-up. Importantly, from a financial consumer protection perspective, it is also difficult to define the concept of an 'informal' lender in Chile with precision, given that – as discussed in section VII below – there is currently no general requirement that entities offering consumer credit need be licensed or otherwise authorized to do so. Only credit providers that are prudentially regulated generally require authorization (other than CCAFs authorized and supervised by the Superintendency of Social Security). In one sense, therefore, even established commercial entities engaging in extensive provision of credit could be referred to as 'informal'. It is

[54] Madeira, C., *Adverse selection, loan access and default in the Chilean Market* (BCCH Working Paper N. 838). September 2019, 6.

[55] Law 19,496 of 1997.

interesting that some of the credit providers that referred to informal lending were themselves not licensed (nor required to be licensed) in order to engage in credit activities and arguably could also be said to be part of the informal lending sector. On the other hand, as discussed below, all credit providers are required to comply with certain financial consumer protection requirements in the Protection of Consumer Rights Law enforced by SERNAC. When referring to concerns relating to informal lending, participants seemed to be particularly focusing on lenders that are both not licensed by CMF and operating inconsistently with the requirements of the Protection of Consumer Rights Law and outside the focus of the general consumer protection authority, as discussed in section VII below. An academic commentator suggested that the informal lending sector covered perhaps 5% to 10% of the population – and some industry participants estimated it to be even larger. They noted that formal surveys showed it closer to 1% but their coverage was likely flawed given that information about informal lending is hard to capture. The 2017 Household Financial Survey report on participants' aggregate "loans from relatives or friends, home loan ("rich aunt"), credit from moneylenders, trust, and other debts". It is understood that the next edition of the survey is in the process of being undertaken. This could be an opportunity for the authorities to obtain more disaggregated data regarding such lending sources, and particularly regarding debts held with different types of non-family/personal money-lenders. Supply-side market monitoring and research is of course also likely to be needed to better understand this lending sector.

37. Multiple banks suggested that interest rate caps had resulted in a significant reduction of credit being offered by licensed institutions to lower income consumers, thus pushing them into the informal lending market. One bank suggested, for example, that 1.5 million consumers left banks when interest rate caps were changed several years ago, and that lower income people had been pushed towards informal lending, with high interest rates and dangerous practices.

D. Financial consumer protection

I. Introduction

38. Financial consumer protection is overseen in Chile by two authorities – SERNAC and CMF. SERNAC, as Chile's general financial consumer protection supervisory and enforcement authority, is responsible for enforcing compliance with the Protection of Consumer Rights Law and regulations issued under that Law. This legislation includes a range of financial consumer protection provisions applicable to any credit provider. CMF is responsible for prudential and market conduct regulation and supervision of the financial sector.

39. Chile has made considerable progress in strengthening financial consumer protection regulation and supervision. A range of consumer protection measures have been introduced over the years, including with regard to product disclosure and conduct regulation, and increasing resourcing and expanding powers for regulators.

40. The various authorities have implemented a range of positive regulatory measures intended to protect consumers and assist their decision-making in relation to acquiring consumer credit. Strong efforts, for example, have been made on transparency and disclosure issues relating to credit, including with regard to the cost of credit. The Protection of Consumer Rights Law has been amended several times to introduce various financial consumer requirements. The Law, and regulations made under it, for example:

- give consumers a general right to receive information regarding the total cost of their credit product, including disclosure of the equivalent annual charge;
- prescribe standardized information that consumers must be provided when considering credit offers and prior to entering into any credit contracts. These include a summary sheet that must accompany credit offers intended to assist transparency and facilitate comparison. Regulations prescribe the content and format for summary sheets;
- require credit providers to make available credit quotes to consumers, that must be valid for at least 7 business days, allowing consumers to compare offers. A range of prescribed information must be included in a credit quote including the amount of credit, its term, repayment amount, total cost, equivalent annual charge etc. followed by additional sections with more detail on costs and other matters such as insurance-related information. (A standardized format is not currently prescribed but it is understood that this is currently being reviewed);
- require that any consumer credit contract contain a range of essential information, including a detailed breakdown of all fees and charges, commissions and costs and fees and when and how these may be varied, and obligation for prior notice of proposed changes;
- require credit providers to give consumers ongoing information (periodically and on request) about their credit contracts, including the total costs charged up to that time, the balance, the remaining term and details of overdue repayments and default charges etc. The content and format are prescribed by regulation. For example, improvements to the existing standardized format for credit card statements were introduced recently. SERNAC, in collaboration with MoE and academic researchers, undertook design of a new mandated standard form credit card statement template intended to simplify information received by credit card customers and to assist them to better understand their financial position.

(SERNAC has also made available a limited 'Consumer Credit Comparator' tool[56] that allows cost comparisons of consumer credit products from several banks for various amounts and periods that can be selected by consumers).

41. A range of measures have also been implemented to address conduct-related risks. For example, a key element for an effective financial consumer protection regulatory framework for credit is a regime addressing the risk of unfair terms included in standard forms credit contracts. These terms may not be clear to a consumer, and they are unlikely to be in any position to negotiate them. The

[56] Available at https://www.sernac.cl/app/comparador/

Protection of Consumer Rights Law contains both a general prohibition on unfair terms in standard form contracts, as well as a list of specific types of terms automatically deemed to be unfair.

42. The authorities have also undertaken some significant enforcement efforts. Examples of these are discussed later in this section in the context of specific issues.

43. Notwithstanding these valuable efforts, there remain financial consumer protection gaps and issues that can contribute to consumer over-indebtedness and other credit-related hardship. This section of the note discusses identified credit-related consumers protection gaps and recommendations for financial consumer protection mitigants to address them. Key gaps and issues identified include:

(i) Credit assessments - a lack of sufficiently specific regulatory consumer protection requirements for loan affordability and suitability assessments to mitigate identified risks of consumers being provided with unaffordable or unsuitable loans;

(ii) Credit-related sales practices and credit product design – problematic industry practices (such as providers incentivizing lending staff based on credit volumes, unsolicited credit offers and extensive bundling of credit protection insurance of potentially questionable value);

(iii) Gaps and deficiencies in credit provider oversight, licensing and supervision, which may be limiting the ability of authorities to detect and address problematic industry practices of the kinds noted.

II. Credit assessments

Findings

Credit affordability

44. Vulnerability to over-indebtedness – particularly for low income households – is of particular concern from a financial consumer protection perspective. As discussed above, while system-wide stability risks from consumer indebtedness appear limited, various indicators suggest that part of the population may have been acquiring unaffordable or unsuitable consumer credit.

45. Credit disclosure measures are unlikely to be sufficient to ensure that consumers acquire credit only when they can afford it and which is suitable for their circumstances. Prior to entering into a new consumer credit contract credit providers are required to disclose to the consumer the repayment commitments, and overall amount, that they would be committing to if they proceed. The Protection of Consumer Rights Law requires credit providers to include, in credit offers and credit contracts, a summary sheet in a standardized format prescribed by regulations. The mandated contents for the summary sheet include the amount of repayments and the total repayable amount for the credit.[57] Credit providers are also required to make to a consumer a credit quote ahead of committing to any contract. The quote must also disclose, among other things, the repayment amount and total cost.[58] Regulations do not mandate a standardized format or template for quotes (as they do for summary sheets) but do require that they must allow the consumer to view their content clearly and simply. While such disclosure requirements – if met – can assist consumers to better understand repayment commitments prior to acquiring consumer credit, they are unlikely to be sufficient to ensure that consumers acquire only credit they can afford and that is suitable for their circumstances. Consumers may lack the skills and level of comprehension necessary to properly assess credit affordability and suitability for themselves. They may also be affected by behavioral biases or other personal circumstances that impair their ability to conduct an appropriate assessment of these matters. It is therefore important that the onus to do so not be placed entirely on consumers, and to avoid excessive reliance on provision of information.[59]

46. To discourage lending to higher indebted borrowers by banks CMF recently introduced rules applying a higher capital charge for those loans, a measure that discourages but does not restrict potentially harmful lending. A capital charge set at 100% is applied for unsecured consumer loans provided by banks to individuals with a financial burden ratio exceeding 25% and debt to gross monthly income ratio exceeding 6.0 (or 50% and 70% respectively if the consumer also holds a mortgage). This is compared to a capital charge of 75% for a consumer with relevant ratios that do not exceed these thresholds.[60] While these measures may discourage such consumer lending by banks to borrowers with higher indebtedness, they do not restrict it. They of course also do not apply to non-bank credit providers.

47. Until now there have not been obligations on all credit providers to conduct pre-contractual assessments for financial consumer protection purposes. These would focus on assessing whether a borrower is likely to be able to repay a debt without undue financial hardship and whether the credit is suitable for the particular consumer's circumstances. The lack of such requirements can result in increased risk that consumers are provided with credit that leads to over-indebtedness or is not suited for their circumstances. Obligations requiring credit providers to assess whether a borrower is likely to be able to repay a debt without undue financial hardship, having regard to their financial circumstances and other existing commitments, are recognized internationally as an essential measure of an effective financial consumer protection framework for credit. As highlighted, for example, in a very recent report by FinCoNet, such a consumer-focused assessment contemplates that a credit provider would need to evaluate the consumer's ability to comply with their repayment obligations under the credit contract to prevent over-indebtedness and eventual default situations. It

[57] Protection of Consumer Rights Law, Article 17C and Regulation on Consumer Credit Information (Decree 43 of 2012 of the Ministry of Economy, Development and Tourism), Title VI.

[58] Regulation on Consumer Credit Information (Decree 43 of 2012 of the Ministry of Economy, Development and Tourism), Articles 4-8.

[59] For example, for a recent discussion by two financial consumer protection regulators responsible for, among other things, consumer credit, regarding limitations of financial consumer disclosure see Australian Securities and Investments Commission and Dutch Authority for the Financial Markets, *Disclosure: Why it shouldn't be the default*. October 2019, https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf

[60] CMF Circular N. 2.281 of 1.12.2020.

may also require a credit provider to refuse to enter into the contract if it is likely that the consumer will not be able to repay the debt within a reasonable time or in a sustainable way even if, from a strict prudential perspective, the risk of the credit contract is acceptable. In some circumstances, this consumer-focused approach may thus result in decisions to decline credit approval that differ from those that would result only from the application of prudential criteria.[61]

48. Providers as well as SERNAC confirmed that previous assessment requirements have been primarily credit risk focused. A range of different provider types (bank, CCAF, credit union and auto finance company) all indicated in discussions that they did not think they had specific consumer protection obligations to assess affordability and suitability of credit. Assessment processes they described seemed to rely heavily on behavioral risk-based approaches. Several banks explained they undertake a credit risk assessment that takes into account various factors, with several banks appearing to place quite a significant focus on behavioral factors, as well as some other element such as and demographic factors, level of current debt etc. One retail credit card issuer with a significant presence in retail malls offers explained that new customers or riskier customers start with small amounts of credit while they build up their behavioral scores as they go along using the credit card. They access some credit bureau data to extent permitted although many applicants don't have a footprint and they obtain self-declarations regarding their existing debt. Several credit card issuers explained that amounts of credit approved for consumers tend to increase over time based on those consumers' repayment behavior. An academic commentator suggested such approaches are typical for retail credit card issuers. In discussions it was mentioned anecdotally that consumers can access credit from some retail credit providers subject only to identity verification and with very little in the way of creditworthiness assessments, given retailers' credit risk appetite for the purposes of growing their business and customer bases. In discussions SERNAC agreed that the current financial consumer protection framework lagged behind with regard to credit affordability and suitability requirements.

49. Some credit providers highlighted significant reliance on the ability to make salary deductions (and thus limit their own credit risk) for the purposes of approving credit applications. A major CCAF, which collects repayments via salary deductions, confirmed that they rely primarily on how much of the aggregate 25% cap on salary deductions remains available when approving credit applications and they do not tend to rely much on factors such as credit registry or bureau data available to them. They acknowledged that how much of the cap on salary deductions is available is not necessarily representative of how much disposable income remains available, given that the borrower may have other debt repayment obligations that are not subject to payroll deduction, as well as living expenses. A credit union similarly confirmed that they rely on salary deductions for the purposes of their main credit offering, a consumption loan. They indicated placing significant reliance on the 25% cap for maximum indebtedness purposes.

50. An equivalent focus on risk mitigation, rather than necessarily individual affordability, was also confirmed by other credit provider types. An auto finance company explained that their credit assessment process did not focus on existing debts and they did not access credit reporting

[61] FinConNet, *Supervisory approaches to consumers' creditworthiness assessments*. November 2021, 7 and 42, http://www.finconet.org/Supervisory-Approaches-Consumer-CWA_2021.pdf

information even to the limited extent available to them. This was both given it was typical for an auto loan to require a significant upfront deposit, and also given borrowers tended to give auto loan repayments priority, thus representing a low credit risk. They also relied (in part given their limited access to external credit reporting information), on their own large internal database of prior customers to consider their past performance when making them new offers of credit. They noted that to compete with alternative sources of credit for auto finance they also needed to be able to make credit decisions quickly.

51. Some credit providers seem to take into account demographic factors that are potentially of concern from a discrimination perspective. Multiple credit card issuers indicated that their credit risk assessment models include relying on demographic factors such as ethnicity, with customers of certain ethnicities tending to be approved for higher amounts than others.

52. A new obligation attempting to close this regulatory gap was introduced at the end of 2021 but it will need to be supported by sufficiently specific and extensive implementing regulations to be effective. The Protection of Consumer Rights Law was amended[62] to oblige all credit providers to assess, on the basis of sufficient information, the consumer's 'financial solvency' in being able to comply with their obligations under a loan. Of itself, the provision would likely be too generic to ensure that all credit providers adopt appropriate assessment standards. The legislation contemplates that MoE (it is understood in conjunction with MoF) may issue implementing regulations under it. In interviews held when the legislation was still in draft, some industry participants suggested that such regulations may be relatively high level. It will be important that the implementing regulations are sufficiently specific to set adequate minimum expectations, while of course also not restricting sensible innovation or approaches. For example, jurisdictions such as the European Union have identified the need to operationalize such general obligations more effectively through more specific requirements. The European Union identified that, unlike the more detailed language found in its Mortgage Credit Directive, there was a lack of clarity in the more general provisions on creditworthiness assessments in its Consumer Credit Directive that resulted in insufficient protection for consumers.[63] The European Banking Authority recently issued new, binding guidelines on loan origination and monitoring that, among other things, set out some more specific detail regarding affordability assessments.[64] A new version of the Directive has also been proposed that would contain clearer and more specific obligations to undertake appropriately proportional information gathering for an assessment of a consumer's ability to repay.[65]

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[62] Law 21,398 of 2021 (known as the "Pro-Consumer Law").

[63] European Commission, *Proposal for a Directive of the European Parliament and of the Council on Consumer Credits*. June 2021, 4-5 https://ec.europa.eu/info/sites/default/files/new_proposal_ccd_en_3.pdf

[64] European Banking Authority, *Guidelines on loan origination and monitoring.* May 2020, https://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring, May 2020

[65] European Commission, *Proposal for a Directive of the European Parliament and of the Council on Consumer Credits*. June 2021, 4-5 https://ec.europa.eu/info/sites/default/files/new_proposal_ccd_en_3.pdf See also country-specific approaches discussed in FinConNet, *FinCoNet report on responsible lending: Review of supervisory tools for suitable consumer lending practices*. July 2014 http://www.finconet.org/FinCoNet-Responsible-Lending-2014.pdf

Credit suitability

53. The new obligation does not include a focus on assessing suitability of the credit for the borrower's circumstances in addition to assessing the borrower's 'financial solvency'. International good practice for responsible lending has been expanding beyond affordability assessment requirements to also include broader concepts of credit suitability. Responsible lending requirements are increasingly comprising not only obligations to conduct an assessment of the affordability of a proposed loan but, at least in some jurisdictions, also whether the proposed loan meets a consumer's needs, requirements and objectives.[66] Based on discussions, the assessment processes of credit providers in Chile do not seem to focus significantly on confirming the suitability of a particular credit product or contract's terms and features for the consumer's needs or circumstances.

54. In a recent policy paper CMF announced that, as part of its market conduct supervision, it will expect institutions that it regulates to take suitability into account and ensure their clients receive products appropriate to their needs. CMF recently issued a policy paper describing the future consumer-protection related focus of its market conduction supervision and which set outs several general financial consumer protection principles that CMF expects institutions it oversees to follow.[67] One of these principles is on fair treatment of clients of financial institutions. The paper explains that, as part of this principle, CMF expects institutions it regulates to take suitability into account and ensure their clients receive products appropriate to their needs. While it is helpful for CMF to emphasize this focus as part of its general market conduct expectations, there do not appear to be any more specific regulatory obligations on credit suitability. In discussions SERNAC noted, for example, that while it was aware of suitability assessment requirements in relation to insurance, there were no equivalent legislative requirements in relation to credit. In addition, CMF's market conduct expectations would not extend to credit providers that it does not supervise. This results in potentially differential treatment of credit providers from a consumer protection perspective and, importantly, in a differing level of protection for consumers with regard to credit suitability issues depending on whether they deal with a provider regulated by CMF.

55. A proposed Financial Innovation Bill[68] would introduce new suitability requirements, but they would not apply to all credit providers. Article 28 of the draft Financial Innovation Bill would introduce new obligations requiring a financial services provider to have appropriate policies, processes and controls in place to ensure that financial products are not offered to consumers if they are not consistent with their needs and expectations. However, the proposed requirements would not apply to all credit providers. Relevantly for credit, Article 28 of the Bill states that it applies to financial

[66] See, for example, the discussion in FinConNet, *FinCoNet report on responsible lending: Review of supervisory tools for suitable consumer lending practices*. July 2014, http://www.finconet.org/FinCoNet-Responsible-Lending-2014.pdf and in World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017, Chapter 1, section C4, https://openknowledge.worldbank.org/handle/10986/28996

[67] CMF, *Policy Paper: Development of Standards and General Principles for Market Conduct relating to Financial Consumer Protection*. June 2021.

[68] Bill to Promote Financial Competition and Inclusion Through Innovation and Technology in the Provision of Financial Services, September 2021.

institutions regulated by CMF (which would include, once it is passed, collective financing platforms such as peer-to-peer lending platforms) and to CCAFs but would not appear to extend to other lenders. This would similarly create a differing level of protection for consumers with regard to suitability issues depending on whether they deal with a provider covered by the Bill.

<u>Implications of credit information system gaps</u>

56. Current gaps and deficiencies in the credit reporting information system can undermine the quality of creditworthiness assessments and potentially cause consumer harm. From a consumer protection perspective, access to accurate, comprehensive credit information for all credit providers can greatly assist them to avoid inappropriately lending to consumers who are already overly indebted or whose credit-related behavior indicates other indebtedness concerns. The current gaps in the credit information system are also likely to limit the benefit to consumers that could result from strengthening credit provider's obligations to undertake better quality credit assessments. Credit providers would lack – to varying degrees – access to information essential to fulfilling such obligations.

57. The credit information system in Chile has been improving but remains fragmented, with gaps in provider coverage and in the types of credit information available to prospective lenders. The system comprises public credit registries administered by CMF and the Santiago Chamber of Commerce and several commercial credit bureaus.

58. The first public registry is administered by CMF and holds only a limited range of positive credit information as well as some negative information. It provides a snapshot of a consumer's current credit liabilities (in aggregate only), but lacks historical information regarding prior loans, repayment history, and historical defaults. The CMF registry provides participating credit providers institutions with a monthly snapshot of obligations per debtor. These snapshots provide information that is disaggregated by product type, but not by provider. CMF will soon introduce weekly snapshots. The registry does not offer credit providers access to an historic database of its data. If credit providers want to have an historic database, they need to build up their own by preserving periodic snapshots provided to them by the registry over time. This means that even credit providers with access to this registry cannot rely on it for essential information to be able to assess a consumer's debt-related history and behavior. In addition, the registry is open only to CMF-regulated credit providers, i.e., banks, bank-affiliated credit card issuers and credit unions, with non-bank credit card issuers to be added soon. Other lenders, such as non-CMF regulated retail credit providers, auto finance companies or CCAFs, cannot currently participate and thus do not even have access to its limited information – such as regarding current debts – for the purposes of their credit assessment processes. They could ask an applicant to obtain the credit report themselves and provide a copy, but this is potentially problematic from another perspective, in that it would not result in a credit application footprint being left by the lender. As an example of the practical implications of this lack of access, raised by industry participants in discussions, consumers can obtain multiple instances of credit from several such providers at around the same time, and none of those providers would necessarily become aware of this. While it was suggested in discussions with authorities that the absence of CCAF reporting would not create a significant gap, it is notable for example, that one CCAF alone reports that they have 800,000 borrowers. Private credit bureaus do not have access to the CMF credit registry (though they have access to the registry of negative credit information administered by the Santiago Chamber of Commerce discussed below) but they can provide services to CMF-regulated clients using data that those clients obtain from the CMF registry.

59. The second public registry is operated by the Santiago Chamber of Commerce and collects negative credit data, mainly from mandatory reporting of dishonored checks by banks and protested promissory notes by notaries public. The Chamber of Commerce administers two registers. The first comprises negative information required to be reported by banks relating to dishonored checks and by notaries public relating to protested promissory notes. The second comprises information that may be reported by commercial entities, such as retailers and health providers, regarding customer defaults on their debts. The incentive for reporting to this register is that reporting can be used to place pressure on customers to repay (as a default can impair their ability to access further credit, and repayment of the debt means the default is wiped from the registry). The Chamber's negative information is held for up to 5 years but is required to be removed immediately once a relevant debt is repaid. Credit providers can access data from the Chamber's registry through commercial credit bureaus, to whom the Chamber sells such data. The Chamber publishes its data sets weekly, being snapshots of existing records, which would then allow bureaus to create an historical database.

60. The Personal Data Protection Law restricts sharing of alternative data, such as relating to utility and telecommunication providers, which could potentially contribute to better credit assessments. The current Law on the Protection of Private Life (commonly referred to as the Personal Data Protection Law or similar) – which was described by several industry participants as significantly outdated – prohibits credit reporting bodies from including alternative credit data from utilities and telecommunications providers. The Law expressly prohibits collection and disclosure of debts with public or private companies providing electricity, water, telephone and gas services. Amendments to the Personal Data Protection Law proposed in draft legislation currently in Congress (which would establish a national data protection regulator and introduce legitimate purpose as a basis for data processing) would not expand CMF's ability to include such alternative data in the registry.

61. Legislation was also under discussion that would delete information on defaults below a certain threshold, which could undermine further the quality of credit assessments for affected consumers. Similar laws were passed in 2002 and 2012. This could further reduce the depth of credit information available through the current system. (In discussions, one commercial credit bureau described repeated instances and continued proposals for deletion of historic negative credit data as 'disastrous' from a credit information perspective).

Recommendations

62. It is recommended that implementing regulations be issued under the new creditworthiness assessment obligation in the Protection of Consumer Rights Law that are sufficiently specific to ensure that credit providers undertake an adequate assessment of a prospective borrower's ability to repay a proposed loan without hardship. Such regulations and supporting guidance should clarify expectations regarding the extent and scope of an affordability assessment, and the steps that the creditor must take to satisfy the requirement that the assessment is a reasonable one, including gathering and verification of necessary information about the prospective borrower. Matters that should be covered in regulations and associated guidance include the kinds of matters expected to be taken into account in such an assessment (income sources, debts, expenses etc.) and the kinds of inquiries a credit provider should undertake and information they should obtain and verify, depending on the circumstances, to support their assessment. If this is not already the effect of the provision in the Law, the regulations should also restrict entry into a contract, or a credit increase, without a satisfactory assessment result.

63. Authorities should progress further expansion of access to credit information to a wider range of credit providers and expand the range of both negative and positive information available to conduct appropriate assessments. Recent regulatory changes should improve availability of information for credit assessments to some extent, but further improvements are needed. The recent changes to credit reporting arrangements discussed in the separate FSA Technical Note on competition in Chile's financial sector that are intended to improve access to CMF's public registry for non-bank retail credit providers from a competition perspective should also assist such credit providers with credit assessments from a financial consumer protection perspective.[69] It is understood further reforms have been proposed, including a new Consolidated Credit Registry Bill currently being considered in Congress. As discussed in that Technical Note, it is important that the authorities progress further both expansion of access to information to a wider range of credit providers (including, for example, to any credit provider licensed under a comprehensive credit provider licensing framework as recommended in section VII below), and expanding of the range of both negative and positive information available to address the gaps noted above.

64. It is also recommended that legal obligations be introduced for credit providers to conduct a proportionate assessment that credit is suitable to meet a prospective borrower's needs, requirements and objectives. If the authorities proceed with introducing the suitability requirements contemplated in the Financial Innovation Bill, these should be made to apply to all credit provider types. Some jurisdictions apply such requirements to provision of credit contracts generally, while others limit this obligation to when providers recommend a specific credit product to a consumer.[70]

65. The authorities should also consider whether stronger anti-discrimination rules and/or enforcement of existing rules are needed to ensure that prospective consumers are not being discriminated unfairly. As noted above, some credit providers indicated that their credit risk assessment models included relying on demographic factors such as ethnicity. A review of Chile's anti-discrimination legislation was beyond the scope of this assessment, but it would be important to

[69] See the discussion on credit information infrastructure in the separate Technical Note produced for the FSA titled 'Competition in the Financial Sector'.

[70] See FinConNet, *FinCoNet report on responsible lending: Review of supervisory tools for suitable consumer lending practices*. July 2014, http://www.finconet.org/FinCoNet-Responsible-Lending-2014.pdf and European Commission, *Proposal for a Directive of the European Parliament and of the Council on Consumer Credits*. June 2021, 22 and proposed Article 16 https://ec.europa.eu/info/sites/default/files/new_proposal_ccd_en_3.pdf

ensure that providers are not discriminating against consumers on inappropriate bases, including ethnicity. Any such discrimination should be prohibited[71] and, if existing requirements already cover this concern, their enforcement should be strengthened.

III. Credit product design regulation

Findings

66. Jurisdictions have been increasingly introducing product design and distribution requirements applicable to credit products. These requirements typically govern how financial products should be designed and distributed so they are appropriate for their target market and are often supported by product intervention powers granted to supervisory authorities. Such requirements have previously been more prevalent in relation to other types of financial products, such as insurance and investments, but their relevance for credit is now being recognized. In effect, they are intended to encourage a consumer-centric approach to designing credit products. Their usefulness has also been increased by the expanding range of credit products and providers and expanding access to credit, with such requirements placing an onus on any provider to ensure their products are appropriate for their target market.

67. Credit providers interviewed for this assessment were not aware of any specific regulations on product design applicable to credit (other than the need to ensure product features meet other regulatory requirements more generally). Several credit providers indicated that their internal focus when designing new products was on profitability and market demand and customer needs. One bank explained that their design of new products is driven by customer wants and gaining a sense of current needs in the market. One bank said they thought there might be some light touch regulation, which may have been a reference to CMF's recently stated market conduct expectations.

68. Current draft amendments to the financial consumer protection framework in Chile do not include product design requirements. As discussed above, a proposed Financial Innovation Bill currently under development would introduce new suitability obligations for at least some credit providers but these obligations do not appear to include product design requirements. The obligations in proposed Article 28 would seem to require providers to undertake individual suitability assessments at the time of offering of a product to a consumer, rather than to ensure the appropriateness of products at the design stage. While these are also very important, they are not the same as product design requirements. Product design requirements apply proactively and at a market-wide level, aiming to ensure in advance that products are not offered outside an appropriate target market.[72] In addition, as already discussed, the proposed requirements would not apply to all

[71] World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017, Chapter 1, section C2, https://openknowledge.worldbank.org/handle/10986/28996

[72] See World Bank Group, *Product Design and Distribution: Emerging Regulatory Approaches for Retail Banking Products (Discussion Note)*. August 2019, 4 for a discussion on this issuehttp://documents1.worldbank.org/curated/en/993431567620025068/pdf/Product-Design-and-Distribution-Emerging-Regulatory-Approaches-for-Retail-Banking-Products-Discussion-Note.pdf

credit providers. The fair treatment principle described in CMF's June 2021 policy paper on its market conduct expectations for financial institutions in relation to financial consumer protection does specify some relevant expectations. Consistently with international developments on product design regulation, these include that financial institutions should take into account the interests and needs of potential clients when developing products, should monitor and adjust products to ensure they continue to meet those needs and should ensure products are distributed consistently with these factors. However, as already noted above in the discussion on suitability, the principles in CMF's paper apply only to CMF-regulated entities and do not appear to have the same status as specific regulatory requirements on these issues. They are also fairly high level, in contrast to the product governance regimes introduced by a range of other jurisdictions.[73]

Recommendations

69. It is recommended that the authorities introduce regulatory requirements for all credit providers to have in place proportionate product design and governance arrangements.[74] These requirements should be designed to ensure that providers' credit products meet the needs of consumers in their target markets and should include, in summary, providers being obliged to: (i) have appropriate and documented internal product oversight and governance arrangements to achieve this overall aim, overseen by senior management; (ii) undertake an assessment of the target market for which a product is being developed (or modified) including, where appropriate, product testing before the product is launched; (iii) ensuring distribution channels are appropriate for consumers in the target market for a product; and (iv) following product launch, requiring providers to periodically review a product and related disclosure materials to ensure continued appropriateness, as well as addressing any issues detected in the meantime. Such requirements should follow a proportionate, scalable approach. That is, they should be flexible enough to take into account the nature, scale, and complexity of a provider's business and complexity and risk of the relevant product. Such overarching obligations are likely to need to be supported by appropriate practical guidance. These requirements could be introduced through the proposed Financial Innovation Bill, for example, but the Bill would need to be amended to include specific obligations relating to product design processes. In addition, unlike the current provisions on suitability in the Bill, such obligations should apply to all credit providers equally.

[73] See FinConNet, *Financial Product Governance and Culture.* July 2021, http://www.finconet.org/Financial-Product-Governance-Culture.pdf and World Bank Group, *Product Design and Distribution: Emerging Regulatory Approaches for Retail Banking Products (Discussion Note)*. August 2019 http://documents1.worldbank.org/curated/en/993431567620025068/pdf/Product-Design-and-Distribution-Emerging-Regulatory-Approaches-for-Retail-Banking-Products-Discussion-Note.pdf

[74] For international examples of such arrangements see the publications by FinConNet and the World Bank Group referenced in the previous footnote. These publications discuss a range of country examples of relevant regulatory regimes that are applicable to credit, such as the European Banking Authority's legally binding *Guidelines on Product Oversight and Governance Arrangements for Retail Banking Products,* available in Spanish as well as English at https://www.eba.europa.eu/guidelines-on-product-oversight-and-governance-arrangements-for-retail-banking-products, or Australia's recently introduced product design and governance regime, described in a recent guide by the Australian Securities and Investments Commission - see https://download.asic.gov.au/media/r2kayocs/rg274-published-11-december-2020-20210901.pdf

IV. Credit-related sales practices

Findings

70. Both bank and non-bank credit providers in Chile are placing increasing emphasis on pre-approved credit offers and more aggressive credit sales and marketing. In meetings with industry commentators, aggressive marketing of consumer credit was noted as a likely key issue for consumer protection going forward. Multiple banks indicated that their use of pre-approved offers of credit was growing, particularly through remote channels. They were increasing use of direct marketing of such offers through digital channels, including online, via mobile apps and SMS. One credit provider noted that, given competitive pressures, they were pursuing pre-approved credit offers for existing customers as well as seeking to compete through initiatives such as simplifying application process, including a streamlined digital application promoting credit as being a few clicks away. Non-bank credit providers such as CCAFs and credit unions similarly noted that they were focusing mostly on direct marketing to existing clients or, where applicable, through employers, and offering of pre-approved offers for existing customers.

71. As is the case internationally, credit marketing in Chile seems to be relying increasingly on individual customer targeting, particularly through digital means, and on emphasizing the speed at which credit approval can be obtained. These approaches and channels can increase the risk of inappropriate credit offers being to consumers, including if credit assessments on which offers are made are inadequate or insufficient. Marketing practices may also exploit behavioral biases by encouraging consumers to make impulsive decisions to take up loans that they do not need or larger loans than necessary. The negative repercussions of aggressive marketing can be heightened by the remote nature and ease and speed of digital transactions, further increasing the possibility of poor decision making by consumers. Lower capacity consumers are likely to be most at risk and measures that rely on consumers' abilities to make appropriate choices and decisions, such as transparency and disclosure requirements, may be ineffective to mitigate relevant risks.

72. There do not currently appear to be regulations specifically addressing pre-approved credit offers. Under the Protection of Consumer Rights Law a credit provider is prohibited from sending a consumer at their home or place of work any unsolicited product or contract. Consumers can also register their telephone number and email address through a 'Do Not Disturb' portal administered by SERNAC to indicate they do not wish to receive advertising and promotional communications.[75] The register appears limited to email addresses rather than all electronic messages/channels. In addition, it does not target credit offers specifically, it is a general measure aimed at preventing marketing calls and spam. A consumer also has a cooling off period of 10 days to terminate a contract, generally without penalty, if they acquire services as a result of a meeting or call arranged by the supplier. However, these measures do not address key risks associated with pre-

[75] See Protection of Consumer Rights Law, Article 28B and https://www.sernac.cl/portal/618/w3-propertyvalue-62998.html

approved credit offers, and particularly made via digital channels. From discussions, this also does not currently appear to be an area of supervisory focus.

73. Most credit providers that were interviewed confirmed that they incentivize the sale of credit by linking financial awards for staff to achievement of sales volumes and targets. A large retail company offering credit cards for use in stores explained that store staff are incentivized to send people to their finance branches to apply for such credit. Multiple banks confirmed that they use sales-based remuneration incentives for staff that assist consumers with credit. A credit union explained that their sales representatives – which go to employers to offer credit to their employees – are paid on a commission basis linked to the volume of loans generated. An auto finance provider explained that two thirds of staff's remuneration comprised a bonus linked to sales.

74. Credit providers' remuneration and incentives for staff generally do not appear to take loan quality (long-term repayment behavior) for loans introduced by staff. A bank noted in discussions, for example, that they did not have policies in place to determine the historic performance of the portfolio of loans sold by any particular loan officer. A large CCAF similarly confirmed that staff incentives are linked to credit sales volumes and do not take into account quality or historic performance of loans made. Inappropriately designed sales incentives can cause conflicts of interesting that lead staff to behave in ways that cause harm to consumers. For example, a credit provider's sales staff may frame information or discussions about credit products in a way that is biased to lead consumers towards options or decisions that will generate the most financial remuneration for a staff member rather than the most suitable or affordable option for a consumer (which may include not proceeding with obtaining credit). Even subtle de-emphasizing of product costs or key features can have a significant impact on a consumer's ultimate decision, particularly if it exploits their existing biases. Sales volume-based incentives may even lead staff to engage in aggressive, high-pressure sales tactics to maximize uptake of a new loan or limit increase or refinancing, when it is not really required by a consumer or a lower amount may suffice. Consumers, particularly less experienced or skilled consumers, can place a significant level of trust in staff with whom they are interacting and on information emphasized by such persons. For such consumers, the communications from frontline staff can resonate more than written disclosure documents information. Potentially harmful behavior from such incentives is not necessarily limited to frontline staff. They may also lead other provider staff to behave inappropriately, such as staff responsible for approving loans or designing market campaigns doing so in ways that prioritize volume maximization over responsible lending.[76]

75. Regulatory measures relating to inappropriate sales incentives and mitigation of conflicts of interest in relation to consumer credit seem to be limited. Various regulatory requirements exist that oblige financial institutions to address potential conflicts of interests in their

[76] See, for example, the discussion in FinCoNet, *Report on Sales Incentives and Responsible Lending - A study of the impact of sales incentives on the sale of credit products.* January 2016.

dealing with clients in relation to products such as insurance[77] and securities and investments.[78] There do not appear to be equivalent regulatory requirements applicable to all credit providers in relation to their credit activities.

76. CMF's June 2021 policy paper on market conduct supervision and financial consumer protection includes a principle on adequate management of conflicts of interest. In describing CMF's expectations on how financial institutions should meet this principle, the paper notes the relevance of remuneration policies, commissions, bonuses and other monetary or non-monetary incentives for both sales staff and management. It highlights that compensation policies that emphasize only sales, without taking into account consumer-related issues, would be contrary to this principle.

77. However, the CMF paper covers only CMF-regulated credit providers and lacks clear implementation expectations. As with other issues discussed above covered in this paper the CMF policy paper applies only to CMF regulated providers. Such principles would also not appear to have the same weight as specific legislative requirements on these issues. The paper provides only limited guidance on credit-specific conflicts issues and even more so on sales incentives in that context.

Recommendations

78. It is recommended that the authorities consider introducing targeted restrictions on unsolicited credit marketing, including via all digital channels. These would be complementary to the measures recommended above to strengthen affordability and suitability assessment, which should go some way to addressing risks associated with pre-approved unconditional credit offers. They would also be in addition to the general anti-marketing calls and spam register currently administered by SERNAC. Recommended targeted restrictions could include allowing consumers to specifically request not to receive unsolicited pre-approved credit offers (or need to opt in to confirm they wish to receive such offers) through any channels, including electronic channels – not limited to emails – through which they communicate with their existing credit provider (e.g. online banking or a proprietary app).[79] Such measures are likely to become more relevant as the market continues to move to digital marketing and high speed distribution of credit.[80]

79. The authorities should introduce regulatory requirements imposing general conflicts of interest mitigation obligations applicable to all credit providers. These should apply through legal provisions that cover a credit provider regardless of whether they are prudentially regulated. They would place an onus on a credit provider to identify and implement measures to address conflicts between their interests or those of their staff and representatives and those of consumers. They should

[77] See rules relating to insurers' management of conflicts of interest in administrative regulation NCG No. 420.

[78] See rules relating to fund managers' management of conflicts of interest in the Single Fund Law (Law 20,712 of 2014), Supreme Decree No. 129 of the Ministry of Finance of 2014 etc.

[79] See World Bank Group, *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017*,* Chapter 1, section C2, https://openknowledge.worldbank.org/handle/10986/28996

[80] See, for example, FinCoNet, *Report on the Digitalisation of Short-term, High-Cost Consumer Credit.* November 2017, http://www.finconet.org/Digtalisation-Short-term-High-cost-Consumer-Credit.pdf

comprise requirements to have adequate policies and procedures and effective organizational and administrative arrangements designed to prevent conflicts of interest from arising or, where this is not feasible, to manage those conflicts to avoid harm to consumers. The authorities could then also issue more granular guidance on minimum expectations regarding specific areas of conflict, including conflicted sales incentives.

80. The authorities should also introduce more specific regulatory requirements to address conflicted remuneration structures and sales incentives implemented by all credit providers. A credit provider should be required ensure that their remuneration arrangements are designed to encourage responsible business conduct by staff and avoid conflicted behavior. This should mean credit providers also taking into account factors such as loan performance, compliance with consumer protection requirements, product retention and outcomes of compliance reviews and complaint investigations. After further assessment of practices in the market the authorities should also consider whether targeted restrictions of specific practices are necessary, such as: banning or prescribing limitations on specific types of incentives or incentive structures where the risk they give rise to is unlikely to be sufficiently manageable; or limiting amounts or variable components of certain incentives (if such additional interventions are found to be necessary).[81]

V. Bundled sale of credit protection insurance

Findings

81. There appears to be a widespread practice by credit providers of bundled selling of credit protection insurance products with consumer credit. Credit protection insurance (also referred to internationally using other terms such as consumer credit insurance or payment protection insurance) refers to insurance that provides cover to at least some extent when a borrower is unable to make credit repayments due to events such as loss of employment, illness, disability or death. Bundling here refers to the sales technique of offering or presenting an additional product, here credit protection insurance, to a consumer together with the product they were intending to acquire, in this case credit. Bundling should be contrasted to tying the insurance, where acquisition of insurance is made a condition of acquiring the credit. Under the Protection of Consumer Rights Law credit providers have been prohibited from some time from tying a credit product with another other product or service. This includes making it a condition of the contract for the borrower to acquire to acquire additional or related products or services.[82]

82. Several credit providers confirmed that they have sold credit protection insurance to a large portion of their consumer credit portfolio. For example, several banks estimated that credit protection insurance was being bundled with up to 80%-85% of their consumer loans. They explained that they were using various incentives to encourage uptake of bundled credit protection insurance

[81] See, for example, FinCoNet, *Guidance to Supervisors on the setting of Standards in the field of Sales Incentives and Responsible Lending*. December 2016 and World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition*. 2017, Chapter 1, section C8, https://openknowledge.worldbank.org/handle/10986/28996

[82] Article 17Ha.

by consumers, such as offering a lower interest rate if the consumer bundles the insurance or allowing the cost of insurance to be included in the principal loan amount. A credit union similarly confirmed that they offer bundled credit protection insurance issued by their subsidiary insurance company with their consumer loans.

83. Credit protection insurance bundling is not necessarily always an unfair practice, but it can cause consumer detriment. This can be the case if it results in consumers purchasing insurance that they do not necessarily want or need and incurring additional costs. Even though the insurance may contractually be optional, its optional nature may not necessarily be understood by a consumer, particularly when it is being presented to them at the same time as they are seeking approval of their credit application, or as a marginal cost to the principal product. Consumers may also be affected by sales techniques (including encouraged by incentives of the kinds discussed above) that rely on behavioral nudges or biases to lead consumers to automatically accepting a bundled offer. Costs for the bundled credit protection insurance may also not be apparent or appreciated, including given the consumer's focus on securing the credit. Consumers may also struggle with identifying whether the credit protection insurance represents good value in their circumstances, including having regard to the kind of coverage offered. Incentives such as interest rate discounts offered by credit providers in Chile could lead consumers to acquiring credit protection insurance product, which they may not need or may not fit their needs, solely to get a discount.

84. The sale of credit protection insurance is viewed as an important component of revenue streams for banks and other credit providers, which can create significant incentive to increase sales. Credit providers internationally have frequently been driven to cross-sell credit protection insurance (and other insurance) aggressively to bolster profits given the potential revenue from sales commissions. The European Insurance and Occupational Pensions Authority recently noted the potential for consumer detriment from high commissions that can lead to unmitigated conflicts of interests and aggressive sales techniques.[83] The ability to pay high commissions can also be an indicator of the insurance representing poor value. For example, in Germany a 2017 investigation by the Federal Financial Supervisory Authority (BaFin) found commissions of up to 50%-70% of premiums were being paid back to credit providers as commissions. Based on discussions, banks and other credit providers in Chile seem to view the sale of bundled credit protection insurance as an important element of revenue generation and profitability, which may also be driven by other pressures on profitability as discussed in the separate FSA Technical Note on competition in Chile's financial sector.[84]

85. Internationally, inappropriate bundling of credit protection insurance with consumer credit has given rise to extensive consumer harm in many jurisdictions and it is important to avoid or mitigate similar issues occurring in Chile. There have been many significant credit protection insurance mis-selling scandals affecting countries' financial sectors. The scandal in the

[83] European Insurance and Occupational Pensions Authority, *Consumer Trends Report 2019*. 2019, 16-19, https://www.eiopa.europa.eu/sites/default/files/publications/reports/2019.6124-eiopa_consumer-trends-report.pdf

[84] See the discussion on bank profitability in the separate Technical Note produced for the FSA titled 'Competition in the Financial Sector'.

United Kingdom is perhaps the most well known, given the size of resulting penalties and refunds. In the UK credit protection insurance sales grew rapidly in the 1990s. Amidst widespread complaints to the regulator about mis-selling practices, and following extensive significant investigations, recent reports suggest that around £270 million in penalties have been imposed and, even more significantly, around £36 billion in compensation have been awarded to consumers. The authorities also implemented a range of measures to address future risks, including prohibiting selling credit protection insurance at the point of sale (it cannot be sold until at least seven days after the loan was agreed – a 'deferred sales model'), banning bundling of the insurance for some loans and much stronger disclosure regarding optional nature of the insurance. The UK is by no means alone in dealing with such issues. In Ireland a review found, among other things, failures to ensure suitability of credit protection insurance being sold, with refunds of over €67 million. A 2019 review in Australia found, among other things, the design and sale of credit protection insurance consistently failing consumers, many products with extremely low payout ratios (indicating poor value for consumers), selling of policies to consumers who were ineligible to claim on them given their personal circumstances, and aggressive sales practices. This resulted in over AU$160 million in refunds by 2020, as well as a further tightening of restrictions. Banks were already subject to a restriction to not sell credit protection insurance until at least four days after a consumer had applied for a credit card or personal loan (a 'deferred sales model"), but additional restrictions were introduced on outbound sales contact.

86. SERNAC indicated that bundling of insurance products with credit was a major cause of consumer complaints they were receiving. SERNAC noted that it had recently entered into a settlement with several insurance companies regarding mis-selling of insurance with retail store credit cards that consumers were not aware of purchasing in the first place. A study of complaints SERNAC had received between mid-2017 and mid-2018 identified as a significant source of complaints charges for insurance that consumers did not believe they had agreed to. During the period analyzed, complaints on this issue grew from 8.37% to 11.12% of all complaints.[85] However, SERNAC explained – for example – that it had not yet undertaken reviews of other issues relating to bundling such as the value or appropriateness of insurance that consumers were acquiring, and how this may have been considered or presented, even if the consumers were aware of the bundling. It is understood that some suitability obligations apply to insurers (under fair treatment obligations).[86] CMF indicated in discussions that insurance bundling had been cause of some complaints. As already mentioned, the recent policy paper issued by CMF – setting out expectations for financial institutions that it regulates – specifies a general fair treatment principle that also refers to suitability.

87. A rule was recently issued requiring consumers to ratify acquisition of insurance products bundled with credit at a later date in order for the acquisition to proceed, but credit protection insurance has been excluded from this requirement. A new article 538(2) of the Commercial Code was introduced recently to prohibit contracting with a consumer for insurance at the same time as they are acquiring, varying or renewing another financial product or service, such as a loan, except for insurance that ensures payment of the consumer's debt or for the protection of

[85] National Consumer Service, *Financial Market Ranking: Retail Credit Cards Sub-Sector*. December 2018, 9.

[86] For example, in administrative regulation NCG No. 420.

assets provided as collateral. Any insurance contracted in contravention of the article will be void. However, insurance will not be subject to the prohibition if the consumer ratifies the entry into the insurance contract within 30 days and premiums may be charged only from the time of ratification. The ratification must state that acquisition of the insurance is voluntary and is not a pre-condition to acquiring the other product (e.g. the new loan). CMF has the power to prescribe insurance that would not be subject to the ratification requirement under article 538(2) and can be contracted at the same time as credit. It recently issued a rule specifying (and thus exempting) credit protection insurance – specifically, insurance the sole purpose of which is to ensure repayment payment of the debt to the creditor is not subject to this requirement provided it comes within specified parameters, including (i) insurance covering the entirety of the debt in the event of death or total or permanent disability above a specified threshold and (ii) insurance covering all or part of the debt in the event of unemployment or various injury or disability scenarios.[87] Insurance over assets provided as collateral for a debt is also exempt.

Recommendations

88. The authorities may wish to consider removing the exception for credit protection insurance from the ratification requirement under article 538(2) of the Commercial Code (which it is understood would require legislative amendments) – if so, it is also recommended that the requirement itself be strengthened. For example, under the current requirement a provider would not necessarily be prevented from seeking ratification of a policy very soon after contracting for the consumer's loans is completed, taking advantage of the initial momentum and context of the credit transaction. This could be insufficient in practice to assist a consumer to consider, and appreciate adequately, the separate and voluntary acquisition of the insurance (notwithstanding the statement indicating voluntariness in the ratification). The authorities should consider prescribing, for example, a minimum time before ratification, separate from any loan process, can be sought, as well as requiring more active steps to adequately separate the ratification – e.g. provision of details of the insurance offer at that later time.

89. Alternatively, it is recommended that the authorities consider implementing other requirements that more strictly target relevant risks for bundled sales of credit protection insurance. As an alternative to merely requiring ratification of an insurance sale, the authorities could introduce requirements for any sale of credit protection insurance to be deferred for a prescribed period, whereby credit protection insurance may be offered only after a minimum prescribed period following acquisition of the loan. Even if such a requirement is adopted, it will be important to ensure that consumers are not subjected to unsolicited contact or high pressure sales of the insurance, as well as that the optionality of acquiring the insurance remains clear.

90. Given the significant focus of credit providers on sales of credit protection insurance it is recommended that the authorities undertake a comprehensive thematic review of current industry sales practices for credit protection insurance. Such review should include assessing

[87] General Rule 460.

whether policies being sold to consumers are suitable having regard to their specific circumstances and represent value, as well as how incentives and commissions are affecting these issues. Consideration should then be given to whether current regulatory measures regarding product suitability need to be strengthened. It should also be considered whether existing obligations on insurers, and other entities that pay commissions to credit providers in relation to the sale of insurance, regarding managing of conflicts of interest arising may need to be strengthened.

VI. Debt collection practices

Findings

91. Debt collection has been consistently identified as a major cause of consumer complaints, with practices by retail credit card issuers and auto finance providers potentially being the most problematic. In a study of 12 months of complaints undertaken at the end of 2018, SERNAC identified debt collection as one of the top causes of complaints (around 18%).[88] In discussions SERNAC confirmed that in the most recent quarter debt collection practices continued to be highlighted by its complaints analysis as one of the highest risk areas of provider conduct. An expert commentator expressed similar views, noting debt collection practices were a major concern due to issues such as very frequent telephone calls and providers engaging in pressure tactics. SERNAC said that debt collection practices by retail credit card issuers and auto finance providers seemed to be the most problematic. Consistently with this, one large retail credit card provider confirmed that they relied heavily on calling debtors frequently for the purposes of debt collection, rather than using a court-enforced debt collection process.

92. Existing debt collection restrictions and requirements in the Protection of Consumer Rights Law and subordinate regulations are being strengthened in response to these continuing concerns, including to limit the times and frequency of debt collection calls. Requirements, as strengthened, include:

- debt collectors being required to inform debtors of various matters (such as the identity of the debt collector as well as the credit provider, and key matters about the debt);
- prohibiting debt collection communications from being represented as part of legal proceedings or credit listings if these processes have not been commenced (as those processes would then attract their own protections);
- importantly, restricting debt collection call days and times (only business days excluding holidays, between 8:00am and 8:00pm) and the number of debt collection contacts (no more than one call or visit per week, or two contacts per week of other types - mail, text messages, emails or instant messaging-, with at least two days passing between contacts).

[88] National Consumer Service, *Financial Market Ranking: Retail Credit Cards Sub-Sector*. December 2018, 9.

During the pandemic, debt collection calls and visits have also been capped to twice a month per debtor; and

- prohibiting disclosure of debt-related information to family members, employers or other unrelated third parties.

Recommendations

93. It is recommended that the authorities focus supervision and enforcement efforts on recently strengthened debt collection requirements and target significant continuing concern with harsh debt collection practices in the market. This should include intensifying supervision of compliance with new stronger restrictions, focusing on higher risk providers, including confirming that providers and their debt collection service providers are implementing changes to their policies and processes to align with improved requirements. Importantly, the authorities should also monitor whether the strengthened regulations are being effective to address the kinds of problematic debt collection practices detected. Significant numbers of consumer complaints and other evidence regarding extensive, problematic debt collection activity can of course also indicate that a significant number of consumers were granted unaffordable credit in the first place. Strengthening requirements regarding credit assessments and credit sales practices as recommended above is intended to also assist with this.

VII. Credit provider authorization framework

Findings

94. The lack of a comprehensive licensing or registration framework for credit providers limits the authorities' abilities to supervise financial consumer protection issues. Currently CMF is responsible for authorizing a range of prudentially regulated financial institutions that may offer credit in Chile. These include banks, certain credit card issuers, some credit unions and even insurance providers that engage in lending. As discussed above, the proposed Financial Innovation Bill would expand CMF's purview to include collective financing platforms such as peer-to-peer lending platforms.[89] Even with this expansion the CMF authorization framework applies largely on the basis of specific provider types, rather than credit providers more generally. CMF shares the identity and relevant information gathered about entities it licenses with SERNAC. However, there is currently no general framework requiring entities offering credit to consumers to be authorized, or registered, before being permitted to undertake consumer credit activities. Such frameworks have increasingly

[89] Bill to Promote Financial Competition and Inclusion Through Innovation and Technology in the Provision of Financial Services, September 2021 – see, for example, Article 2.

been recognized as good international practice to assist financial consumer protection supervision,[90] and have been adopted by a range of countries.[91]

95. Credit providers can apply to SERNAC to receive the SERNAC Seal', which involves some vetting by SERNAC, but participation is optional and not intended as a form of authorization. A credit provider, whether or not already licensed by CMF, can apply to SERNAC for permission to display the SERNAC Seal in its documents, website and other communications. The SERNAC Seal is intended to indicate to consumers that a credit provider complies with certain legal consumer protection requirements relating to contracts and complaints handling. To be granted this Seal, a provider must submit all relevant standard form contracts for review. SERNAC must then verify, among other things, that the standard form contracts conform to the Protection of Consumer Rights Law and regulations under it. A provider must also demonstrate to SERNAC that it has an internal consumer complaints and inquiry handling function that meets various requirements. It must also agree to participate in an external dispute resolution service administered by SERNAC that includes use of arbitrators. SERNAC has sixty days to complete its review of an application (which may be extended by the Minister of Economy, Development and Tourism to 180 days on request by the Service if the number of contracts submitted exceeds the review capacity). If SERNAC does not do so within the timeframe, the provider appears to then receive the seal by automatic force of law.

96. The SERNAC Seal seems to present potential risks for both SERNAC and consumers. The approval process appears to potentially expose SERNAC to a significant burden, and risk, as a government authority effectively confirming legal compliance of a provider's contract in advance. Matters such as ensuring compliance with unfair contractual terms requirements could be more appropriately dealt with through supervision, and ensuring that providers give consumers access to appropriate complaints handling mechanisms could be better addressed initially through licensing and vetting and subsequently through ongoing supervision. It is also not clear whether consumers would understand the limitations of what the Seal means when dealing with relevant providers, such as potentially misunderstanding, for example, that they cannot challenge a standard form contract previously 'approved' by SERNAC.

97. In any case, so far no credit provider has applied for the SERNAC Seal. SERNAC suggested in discussions that this may be due to providers' reluctance to commit to some of the additional requirements with regard to complaints handling for grant of the Seal.

98. Entities not already subject to authorization by CMF may therefore offer consumer credit without being subject to any vetting. As discussed above, the proposed Financial Innovation Bill would expand CMF's purview to include collective financing platforms such as peer-to-peer

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[90] See, for example, the discussion on licensing and registration in World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017, Chapter 1, section A1, https://openknowledge.worldbank.org/handle/10986/28996

[91] For example, in the UK any firm undertaking any regulated activity – which includes providing or intermediating consumer credit, among a range of activities– requires authorization from the Financial Conduct Authority. For a high level summary in Spanish of the British authorization regime see https://www.fca.org.uk/firms/autorizacion (for more detail specific to credit providers, see: https://www.fca.org.uk/firms/authorisation/how-to-apply/lending)

lending platforms.[92] However, even with this expansion the current CMF authorization framework continues to apply largely on the basis of institution/service provider-type.

99. Consumer borrowers in Chile therefore risk dealing with lenders that do not meet any minimal standards for competence, capability and integrity. A licensing framework that applied to consumer credit providers more comprehensively would provide an opportunity for the authorities to undertake an initial, upfront assessment of all prospective providers. This could include at least some level of assessment of their management and confirmation they have initial systems and controls to comply with financial consumer protection requirements.

100. Licensing, or even a lighter-touch registration framework, would also assist ongoing monitoring and supervision. Licensing or registration would facilitate capture of upfront information to assist the authorities with ongoing market monitoring and FCP supervision. In discussions SERNAC expressed concern regarding its ability to identify and monitor all new entrants in the credit market, given the lack of any need for credit providers to be registered. SERNAC said, for example, that over-indebtedness seemed more of an issue in the informal credit sector that was mostly out of its purview given there are no requirements for credit providers to register with them. Some industry participants also expressed the view that 'unregulated' credit providers presented some of the bigger risks for low income consumers. Technically all credit providers would be regulated in the sense of being within SERNAC's purview given that the Protection of Consumer Rights Law applies to all lenders. However, it is more difficult for SERNAC to have comprehensive oversight of those that are outside of CMF's licensing regime, and even more so for those that are less prominent or established in the market. This may become an even greater practical issue as the market develops and new kinds of entrants participate, such as new types of fintech lenders whose activities are not subject to any authorization by CMF.

101. Requiring licensing or authorization for all credit providers would allow the authorities to impose conditions on credit providers where appropriate. These could include conditions requiring a credit provider to have in place financial consumer protection measures to be permitted to undertake credit activities, such as having in place arrangements to mitigate conflicts of interest affecting credit activities as discussed above, or participating in an external dispute resolution service to deal with consumer complaints that the provider has not resolved satisfactorily. Doing so would thus provide the authorities with additional regulatory as well as supervisory and enforcement flexibility.

Recommendations

102. It is recommended that the authorities introduce a licensing, or at least lighter touch authorization/registration framework, for all credit providers. This framework should apply on an

[92] Bill to Promote Financial Competition and Inclusion Through Innovation and Technology in the Provision of Financial Services, September 2021 – see, for example, Article 2.

activities-basis, rather an institution-type basis, to ensure it is sufficiently flexible to cover different kinds of providers and adapt to new entrants and credit offerings over time.

103. The authorities should consider carefully which authority would administer this framework. As one example, SERNAC could be responsible for licensing/registering all credit providers, but lenders already licensed (and thus subject to vetting) by CMF could be subject to a lighter-touch licensing process or a mutual licensing arrangement. It is also recommended that this new framework replace the SERNAC Seal initiative.

VIII. Financial consumer protection supervision for credit

Findings

SERNAC

104. SERNAC is Chile's general financial consumer protection supervisory and enforcement authority and is responsible for enforcing compliance with the Protection of Consumer Rights Law and regulations issued under that Law. The Protection of Consumer Rights Law is Chile's primary general consumer protection law but, as discussed above, it also comprises a range of specific financial consumer protection provisions applicable to credit. Any commercial entity engaging in the provision of credit is required to comply with the requirements of this Law. The law has been amended extensively over time to include a range of financial consumer protection requirements. As a government agency SERNAC reports to MoE. MoE is also the Ministry that issues regulations under the Protection of Consumer Rights Law.

105. As a result of recent reforms to the Protection of Consumer Rights Law, SERNAC assumed an expanded supervisory role in March 2019, including with regard to requirements under the Law relating to credit products and providers. Pursuant to recent amendments to the Protection of Consumer Rights Law SERNAC now has a clearer mandate and a broader range of powers to supervise compliance with the Law, as opposed to simply undertaking enforcement action when breaches are detected. This includes being able to undertake onsite inspections as well as offsite supervision, and to compel providers and individuals to provide it with documents, records and other information.

106. SERNAC has sought to take a risk-based approach to its financial consumer protection activities. It explained that it has developed an elaborate complaints analysis tool that allows it to disaggregate complaints data and identify trends and provide a risk-based approach for their activities that leverages that data and some other inputs such as social media monitoring. A risk-based approach is particularly important given the limited resources SERNAC has at its disposal to cover a wide range of providers and products. A United Nations expert panel recently noted that, given the large number of markets and industries SERNAC has authority to investigate, the growing number of complaints it receives from consumers, and its finite resources, SERNAC prioritizes its activities by focusing on markets recognized as particularly sensitive, conduct on the part of suppliers that is considered to be aggravated, and strategic factors. The panel also mentioned that SERNAC had not yet issued objective criteria it uses for such prioritization.[93]

107. SERNAC's activities with regard to credit providers appear to have been largely focused on offsite market monitoring and there does not seem to be a systematic offsite and onsite inspection program of providers. In discussions, SERNAC described its financial consumer protection role in relation to credit as comprising market monitoring and enforcement. Its market monitoring relies to a significant extent on complaints data analytics. Credit providers indicated in meetings that they receive periodic thematic information requests from SERNAC on specific issues of interest. However, they generally do not appear to have been subject to entity-specific offsite inspections or onsite visits (including prior to the pandemic limiting the feasibility of onsite inspections). This could be a practical reason why, for example, an expert commentator expressed the view in discussions that SERNAC's consumer protection activities in relation to credit appear to be very reactive (e.g. in seeking remediation of consumer harms once they rise to a significant impact) and less proactive (such as in terms of early detection or prevention). For example, a non-bank retail credit provider may have very limited regulator interactions relating to consumer protection, not being regulated at all by CMF and having limited dealings with SERNAC.

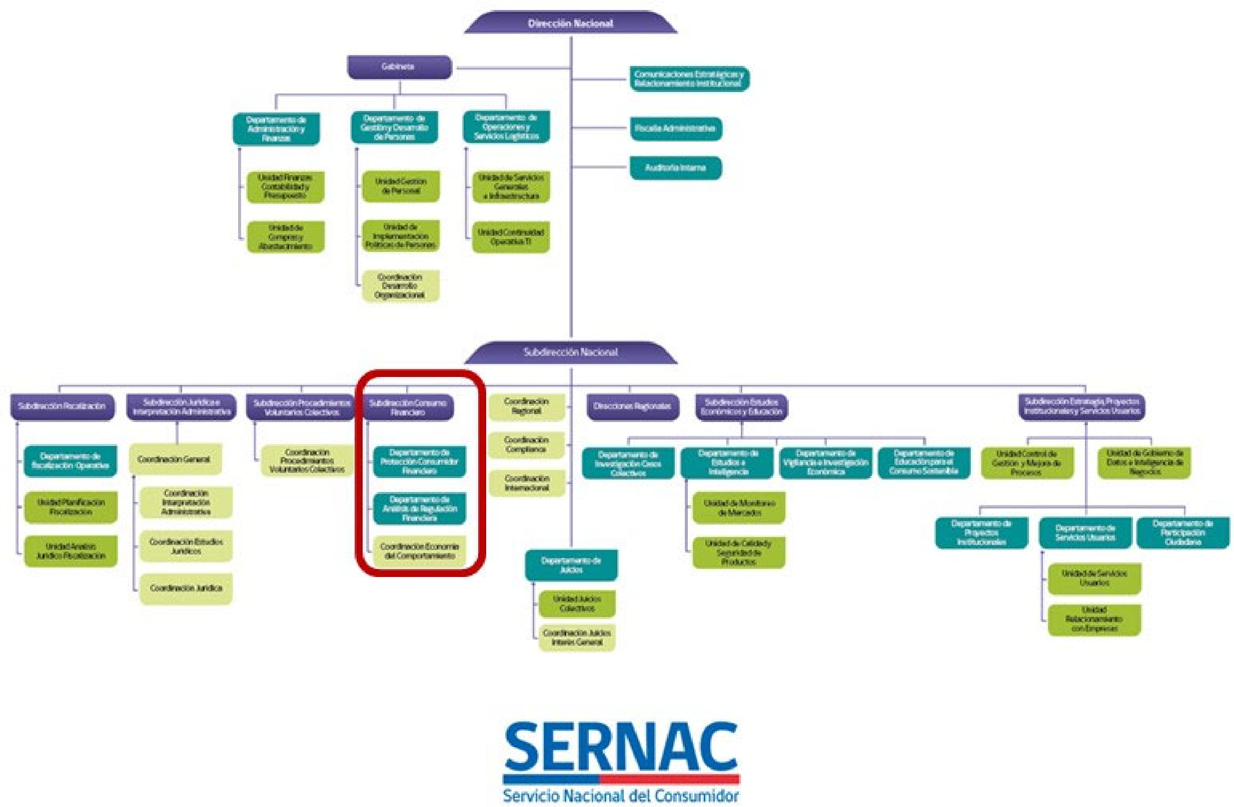
108. SERNAC's enforcement activities so far have been largely focused on class actions and compensation settlements with providers. In discussions both commentators and SERNAC indicated that for significant consumer issues SERNAC has tended to institute collective court actions, typically to obtain compensation. SERNAC has instituted such actions – and arrived at settlements with providers – in relation to a number of issues, such as against several insurance companies regarding mis-selling of credit-related insurance and against banks in relation to charging of fees for services already covered by existing fees. SERNAC explained in discussions that its inability to impose sanctions without needing to take court action has also undermined the effectiveness of its enforcement. It has sought to address this through other initiatives, such as a naming and shaming program. Using the complaints data that it collects, SERNAC publishes various reports signaling misconduct to the market, focusing on unresolved complaints or justifiable complaints not resolved in consumers' favor. Since the introduction of this program SERNAC said it saw some positive results from industry, such as consumer credit providers linking their management's remuneration to their ranking on naming and shaming reports.

109. SERNAC has been allocated additional resources as a result of recent reforms but the current setup presents potential organizational challenges for consumer protection supervision of credit providers. SERNAC has a dedicated 15-person financial sector unit that focuses on financial consumer protection (see Figure 7 below, indicating where this unit sits within SERNAC's organizational structure). This unit undertakes financial consumer protection market monitoring and some enforcement. The unit coordinates with and needs to leverage various separate general units within SERNAC for other activities, including SERNAC's general inspection unit, complaints management unit and litigation unit. This seems to mean that, in practice, financial consumer

[93] Intergovernmental Group of Experts on Consumer Protection Law and Policy - United Nations Conference on Trade and Development, *Voluntary peer review of consumer protection law and policy: Chile.* April 2021, 7.

protection would be vying for resources and priority with a range of other areas, as well as leveraging functions, such as inspectors, that may not be financial sector specialists.

Figure 9: SERNAC organizational chart



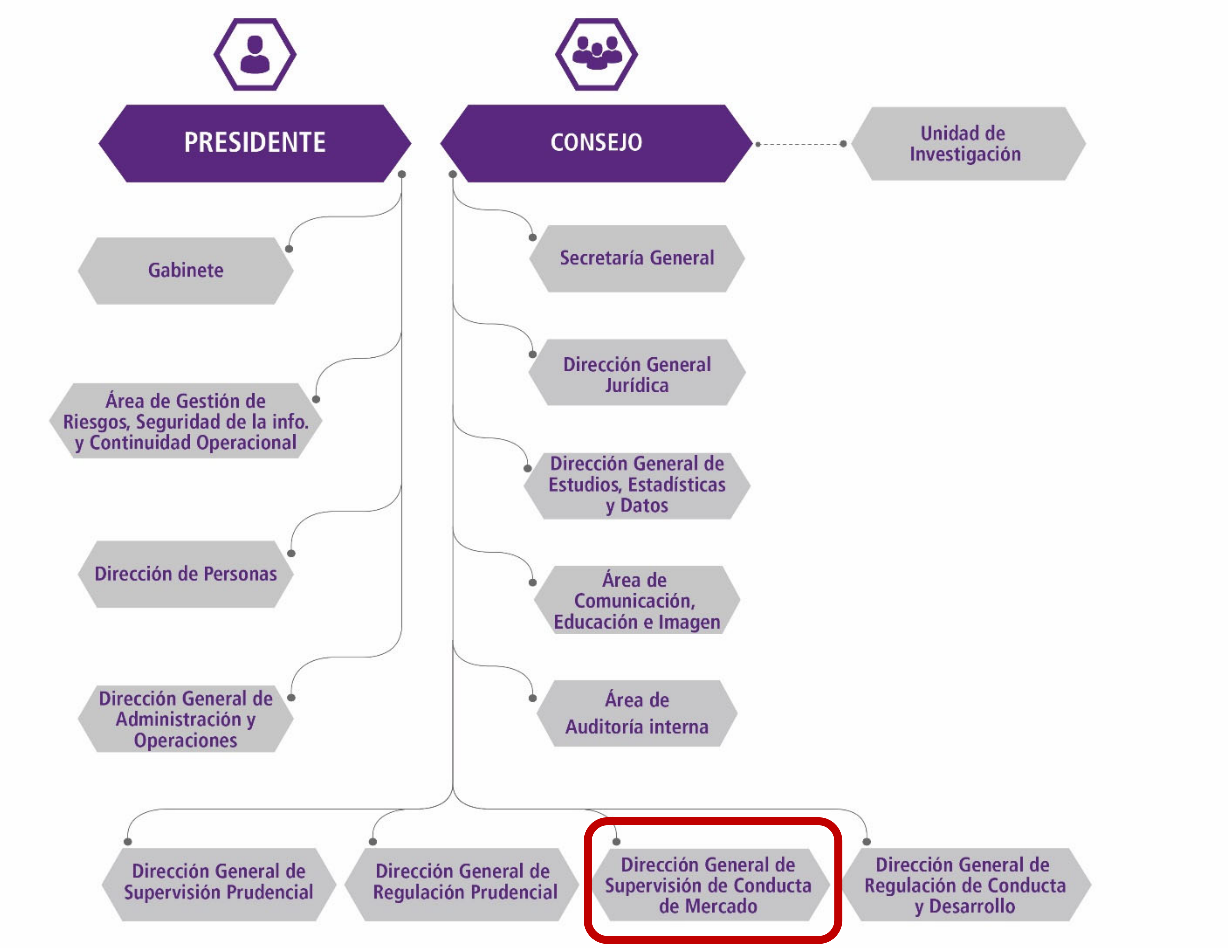
Source: SERNAC website (https://www.sernac.cl/portal/617/w3-propertyvalue-14922.html), emphasis added

CMF

110. CMF is responsible for prudential and market conduct regulation of the financial sector. CMF was established in February 2017 and on 1 June 2019 it replaced and assumed the responsibilities of several previously existing regulators, including the former Superintendency for Banks and Financial Institutions and the former Superintendency for Securities and Insurance. As a government agency CMF reports to MoF.

111. CMF has adopted an internal 'twin peaks' organizational structure intended to align with its dual prudential and market conduct mandate. CMF has moved from institution-based directorates to organizational arrangements comprising separate directorates and resourcing for prudential supervision and market conduct supervision (see Figure 8 below, indicating where the market conduct supervision directorate sits within SERNAC's organizational structure).

Figure 10: CMF organizational chart



Source: CMF (https://www.cmfchile.cl/portal/principal/613/w3-propertyvalue-25543.html), emphasis added

112. CMF's current regulatory and supervisory mandate extends only to some credit providers, which can result in differential treatment of providers and levels of protection for their consumers. For example, as discussed above, the financial consumer protection principles set out in CMF's June 2021 policy paper on market conduction supervision and consumer protection extend only to financial services providers that CMF regulates. This results in potentially differential treatment of credit providers from a consumer protection perspective and, importantly, in a differing level of protection for consumers depending on whether they deal with a provider regulated by CMF.

Supervisory and regulatory overlap

113. There appears to be overlap between SERNAC's and CMF's mandates when it comes to financial consumer protection supervision in relation to credit providers regulated by CMF. CMF explained in discussions that its financial consumer protection mandate for credit is not currently well-defined. Nevertheless, it has responsibility for supervising compliance by financial institutions (including whose business activities include the provision of credit) of a range of sectoral laws covering various consumer protection issues.[94] The proposed Financial Innovation Bill discussed above would expand CMF's purview to include collective financing platforms such as peer-to-peer lending platforms.[95] Notably, the already mentioned policy paper recently released by CMF describes a range of overarching financial consumer protection principles that CMF expects institutions it oversees to meet from a market conduct perspective. These principles include fair treatment of consumers, adequate management of conflicts of interest, protection of customer information, transparency in disclosure and advertising of financial products and appropriate complaints handling. Given their broad and comprehensive nature, the principles clearly overlap in substance with areas and issues covered by more specific requirements in the Protection of Consumer Rights Law enforced SERNAC (for example, the principle on disclosure and transparency vs the range of disclosure requirements in the Protection of Consumer Rights Law). This means that, in practice, both regulators could undertake supervision in relation to some of the same areas of consumer risks and incidents.

114. Chile is among a small number of countries internationally where the general consumer protection authority and financial sector authority share financial consumer protection supervision responsibilities. For example, only 9% of jurisdictions that responded to the World Bank Group's last Global Financial Inclusion and Consumer Protection Survey indicated that they had such an arrangement.[96] International good practice also highlights[97] the importance of minimizing the overlap between the mandates of different authorities implementing financial consumer protection. This is important for a variety of reasons, including avoiding potential confusion and inefficiencies for providers, different approaches and treatment by agencies and maximize the efficient use of regulatory resources.

115. SERNAC and CMF have a recently updated memorandum of understanding in place to assist coordination of activities but coordination appears to need improvement. It is also understood that, for example, CMF shares information about the credit providers that it authorizes with SERNAC. However, based on discussions with the regulators and other participants, it seems that CMF and SERNAC currently do not coordinate supervision activities (for example, CMF was not aware of the level of supervision activity over credit providers conducted by SERNAC) and that exchange of

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[94] See CMF, *Policy Paper: Development of Standards and General Principles for Market Conduct relating to Financial Consumer Protection – Annex 2*. June 2021.

[95] Bill to Promote Financial Competition and Inclusion Through Innovation and Technology in the Provision of Financial Services, September 2021 – see, for example, Article 2.

[96] World Bank Group, *Global Financial Inclusion and Consumer Protection Survey*. 2017, 4.2 https://openknowledge.worldbank.org/bitstream/handle/10986/28998/122058.pdf?sequence=5&isAllowed=y

[97] See, for example, World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017, Chapter 1, section A2, https://openknowledge.worldbank.org/handle/10986/28996

information for supervision-related purposes has been limited. Where different authorities have been made responsible for implementing the financial consumer protection framework for the same providers (as is the case, for example, in relation to credit providers supervised by both CMF and SERNAC) international good practice makes clear that effective coordination is crucial[98] to minimize some of the issues identified above. The importance of strengthened coordination was also acknowledged in CMF's recent policy paper.

116. Improved coordination may not necessarily be able to address some of the issues arising from the current arrangements and consideration should also be given to whether changes to the existing framework are needed. For example, as noted above, the general financial consumer protection principles to be supervised by CMF will apply only to some credit providers, given that CMF can only make rules for the financial institution types that it regulates. This is likely to result in different treatment of credit providers, and different levels of protection for consumers they deal with, depending on the credit provider type. It is an important aspect of international good practice that the financial consumer protection framework should be consistent, including across regulations issued by different authorities with respect to similar products and providers. It is not entirely clear, without a more extensive review, how these issues can be best and most feasibly addressed in the context of Chile – such as through changes to CMF's and SERNAC's respective mandates, replacement of CMF's institution-specific framework and of institution-specific rules with a common framework applicable to all providers etc.

117. To address financial consumer protection issues effectively over the long run financial consumer protection supervision in Chile will need sufficient resources and expertise, dedicated capacity that avoids competing with other supervision priorities, and consistent approaches across credit provider types. This becomes even more crucial given new and increased risks from digitalization, increasing complexity of products and the need to supervise an expanding range of products and market participants which will bring new challenges for financial consumer protection.

Recommendations

118. It is recommended that the authorities undertake a comprehensive review of current financial consumer protection supervision and regulation arrangements, resources and processes against international good practices[99] to determine:

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[98] See, for example, World Bank Group. *Good Practices for Financial Consumer Protection: 2017 Edition.* 2017, Chapter 1, section A2, https://openknowledge.worldbank.org/handle/10986/28996

[99] For example, as described in publications including the World Bank's Good Practices for Financial Consumer Protection (https://www.worldbank.org/en/topic/financialinclusion/brief/2017-good-practices-for-financial-consumer-protection) and publications by the G20-OECD Financial Consumer Protection Task Force (see https://www.oecd.org/finance/financial-education/g20-oecd-task-force-financial-consumer-protection.htm) and FinCoNet (see http://www.finconet.org/).

(i) whether Chile has in place the most appropriate institutional arrangements in its country context to support adequate resources, specialized expertise and independence for financial consumer protection supervision into the future, and to avoid regulatory gaps going forward;

(ii) appropriate supervisory processes, data infrastructure and dedicated expertise are in place for effective supervision of the expanding range of consumer issues and products.

The authorities should then implement any changes determined to be necessary to ensure these aims are achieved.

While this recommendation focuses on consumer protection supervision in relation to credit, given the scope of the review in this FSA, it is suggested that any such review should cover all financial consumer products/sectors. The review should obviously involve CMF, SERNAC and their respective Ministries.