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Comments on “The rol of conglomerates in Chile”

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In these comments we briefly summarize the report, discuss its main findings and comment on the policy recommendations.

A brief summary...

The focus of the report is how conglomerates in the Chilean economy may be affecting competition and may also be affecting policy making in general because of undue influence on the executive, supervisors, and congress.

The report starts by discarding reasons for why conglomerates may be an efficient ownership structure: internal capital markets, internal labour markets, economies of scale and leverage of a scarce resource. The report argues that technology has reduced the relevance of internal labour markets and economies of scale, while leveraging a scarce resource fails to explain why conglomerates are only prevalent in some countries. As for the role of internal capital markets, the report argues that the relative depth of the Chilean capital market has made internal funding markets unnecessary.

Having discarded that conglomerates may be an efficient response to the current characteristics of the Chilean economy, the report focuses on two mechanisms through which conglomerates may be the response to rent seeking behaviour – leading in turn to lower levels of competition across markets and distorting economic policymaking in general.

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The first mechanism relates to the presence of banks in conglomerates. Theoretically, banks could distort competition by lending to related firms in favourable terms, or by blocking finance to firms that may compete with the other activities of the conglomerate. For Chile, however, the report argues that preferential terms of financing to related firms is unlikely to be affecting competition. Indeed, the Chilean legal framework places strict limits on related lending from banks and other financial institutions and prohibits financial institutions from lending on more favourable terms to related firms³. On the other hand, the report suggests that conglomerates may be distorting competition by restricting bank funding to competing firms, something that we argue below is unlikely to be the case in Chile.

The second form of rent seeking relates to the undue influence conglomerates may have on economic policy via the financing of the political process, favourable lending to officials by banks or by promising future employment to high level government officials (a revolving door).

To avoid negative effects on competition by banks in conglomerates, the report proposes restricting directors from sitting on boards of banks and real sector firms, and that voting rights be eliminated for all shareholders of banks above a certain threshold. The report also argues for changes in taxation, that would make pyramidal control schemes more costly and for publicly available data on ultimate ownership – which would further enhance supervision and private sector monitoring of related party transactions. To limit undue influence the report proposes carefully evaluating recent changes in campaign financing law, significantly increasing restrictions on post-employment of public officials, and introducing conflict of interest regulation for officials entering senior posts from the private sector.

Comments on the findings...

This report raises several topics that are potentially very relevant for competition and economic policy in Chile. It provides theoretical arguments, some examples, and a list of potential policy tools. It is, therefore, a starting

³ The Chilean banking law restricts related party exposures (Art 84.2). There are also quantitative limits to related lending in the insurance law and in broker-dealer regulation. The banking law also requires that loans to related parties cannot be more favourable in terms of maturity, interest rates or collateral requirement than similar loans to non-related parties. In addition, the *Ley de Sociedades Anónimas* (the Chilean corporation law) regulates the conditions for related party transactions. This law states (Art147) that all related transactions must be similar in price, terms and conditions to arm's length transactions. This legislation was strengthened with the recently approved *Ley de Agentes* (Law 21.314), and the CMF has issued regulation in this matter. This regulation requires that related party transactions be publicly reported twice a year.

point for a data driven discussion on some of these topics.

Our first comment is that the concerns raised by the report regarding undue influence in policy making are more closely related to the concentration of assets and wealth than with the presence of conglomerates, a point the author recognizes in the conclusion. In a small economy with a high level of wealth inequality, safeguarding economic policy from undue influence is a key priority – as some of the examples included in the document show. However, the report does not focus on the distribution of wealth, but on the specific role of conglomerates on undue influence. These two factors may well be correlated, for policy recommendations however, the distinction is important.

The author presents two mechanisms through which conglomerates can exert undue influence. The first, is that Conglomerates that include a financial institution, in particular a Bank, can use access to credit to expand their political influence. The second is that by operating in several markets, conglomerates can make it easier to reward or retaliate against a regulator if it acts in favour or against the economic group.

Although both effects are conceptually plausible, it is not clear how relevant they are in distorting actual policy making. If, for a given level of wealth distribution, economic policy distortions are much larger in the presence of conglomerates, then limiting the size or complexity of conglomerates or prohibiting banks within conglomerates should be a policy priority. If, on the other hand, the main risks arise from wealth concentration, then the costs of intervening the structure of conglomerates could outweigh the benefits and may in fact be a distraction from the main policy priority: to further reforms aimed at shielding policy making from undue influence. High levels of wealth concentration are a significant issue in Chile. However, it is not clear to what extent conglomerates exacerbate this problem or if they are primarily a byproduct of wealth concentration without adding additional concerns beyond the concentration itself.

Our second comments is that much more careful data driven analysis is needed to discard efficiency reasons for conglomerates and to evaluate the potential negative effects on competition that the report mentions. This analysis is key to being able to determine policy responses. Policy discussion should be based on the importance of the distortion, the efficiency of the proposals in tackling the rent seeking behaviour, and the potential transition and permanent costs of doing so.

In relation to the efficiency reasons for conglomerates: it is not evident that internal capital markets do not play a role in explaining the existence of conglomerates. Although Chile has a relative deep capital market, this does rule out capital being cheaper within the group. Simply as a reference, corporate lending rates for the highest rated firms (AAA, AA and A corporates)

are respectively 1%, 1,5% and 2,3% above the sovereign rates⁴. Conglomerates may also play a role in accessing global capital markets via bonds. Although Chilean banks can (and do) issue bonds to finance local lending, borrowing from banks is more expensive for firms than issuing bonds in global markets. Interestingly recent research Calomiris et al (2022) find evidence of a minimum size threshold when accessing international bond markets⁵.

More evidence is needed to sustain the hypothesis put forward in the report that competition in Chile is being hurt because of banks limit financing to entrants that try to compete with firms in the conglomerate. For a start, the structure of the Chilean banking sector raises doubts about the relevance of this mechanism. There are 14 banks operating in Chile, several of them offering services in multiple product lines⁶. Moreover, concentration indicators are not far from averages for mid-sized economies. For example, the assets of three largest commercial banks as a share of total commercial banking asset are 52% for Chile, while the world average is 67%, and for the 27 OECD countries 67%. More importantly for the issues flagged in the report, 4 of the 6 largest banks do not belong to a business group with any real sector activities. In addition, Santander, Scotiabank and Itaú are controlled by global or regional banks, and Banco Estado is state-owned. Hence, it seems highly unlikely that any individual bank could block the entrance of a firm to a market even if it wanted to. Moreover, banks are only one sourcing of funding for firms. Factoring firms, leasing firms and private debt funds all compete with banks in funding firms⁷. Finally, in the last two decades, there have been a couple of conglomerates that decided to sell their financial institution or reduce their their share in bank property. Grupo Paulman closed Banco Paris and Grupo Said has significantly reduced their participation in Scotiabank. This behaviour is not consistent with the presence of large rents from owning a bank within a conglomerate.

We also have doubts regarding one of the main empirical findings of the paper: that firms belonging to a conglomerate consult more banks and face lower credit rejection rates. First, the differences between search efforts are not consistent across years and firm sizes, and in those cases where firms in conglomerates search more, the differences are probably not statistically significant. Although the data for rejection rates seems to be very noisy (for example rejection rates of small-2 firms in conglomerates jumps from 0% to 15% in two years) it does paint a more systematic picture of lower rejections for

⁴ Data for 2023, source Central Bank of Chile.

⁵ Calomiris, Charles W. & Larrain, Mauricio & Schmukler, Sergio L. & Williams, Tomas, 2022. "Large International corporate bonds: Investor behaviour and firm responses," *Journal of International Economics*, Elsevier, vol. 137(C).

⁶ There are also 3 branches of foreign banks in Chile.

⁷ Banco Central de Chile, Informe de Estabilidad Financiera 2do Semestre 2023.

firms in conglomerates. One explanation for this finding is the one put forward in the report: banks prioritize lending to firms in their groups. However, it is unlikely that the “small” firms in the ELE survey belong to an economic group that includes a bank. These are very small firms and conglomerates that own banks are mostly made up of larger firms. An alternative explanation is that firms in conglomerates are better managed or are more credit worthy than “stand alone firms” because of support from the conglomerate. Better management would also explain differences in search efforts.

The report includes some interesting data on product price differences. Specifically, the report argues that high prices of food in Chilean supermarkets, relative to neighbouring countries, may be due to supermarkets being part of a conglomerate. However, it is hard to explain why food is relatively expensive in Chile, but clothes are cheap, considering that several of the largest supermarkets and retail stores are also part of the same conglomerates. In addition, several of the products listed have specific taxes that vary across countries. As an example, the tax on alcohol is almost an order of magnitude higher in Chile than in Peru. Finally –by Balassa Samuelson one would expect higher wages in Chile, and hence higher prices for non-traded goods. As a large share of fresh food products are not traded, this could also be behind the findings.

Comments on the recommendations...

We fully agree with the report on the need to move forward with a robust final ownership registry. This is not only important for safeguarding competition, but also to strengthen financial supervision, to combat crime and money laundering and to reduce tax evasion. Currently there is a bill being discussed in the Chilean Congress which would create a Registry of Final Beneficiaries (*Boletín* N° 16.475-05). The information in the proposed registry would be public for entities that contract with the state or receive tax benefits from donating.⁸

We also agree on the suggestion in the report to allow time to evaluate the effectiveness of recent reforms regarding the financing of politics in Chile. The *Observatorio Anticorrupción*, finds that although there has been an important improvement in the way politics is financed in Chile in recent years there are still gaps remaining.⁹

⁸ There is no clear OECD standard on the disclosure of the registries: <https://oo.cdn.ngo/media/documents/oo-briefing-public-access-briefing-2021-05.pdf>

⁹ *Observatorio Anticorrupción* is an independent organization that monitors progress in the reforms proposed by the *Consejo Asesor Presidencial Contra los Conflictos de interés, el Tráfico de influencias y la Corrupción* (a presidentially mandated committee often called Comisión Engel). <https://observatorioanticorruccion.cl/cumplimiento.html#fulfillment-1>

We also agree with the report on the need to continue to strengthen institutions and disclosures to limit undue influence from large corporations and wealthy individuals on policy making. We believe, however, that alternative approaches could be as effective as those proposed in the report. The report proposes that banks disclose loans to Politically Exposed Persons or that they be communicated to the CMF. However, Chile already has a system for reporting assets and liabilities of public authorities. This *Declaración de Interés y Patrimonio (DIP)* must be completed by many public authorities. For senior authorities the DIPs are made public. Hence, it is worth analysing whether DIPs could be complemented to include terms of the credits, in addition to other needed changes also flagged by the *Observatorio Anticorrupción*, instead of generating a parallel mechanism.

Having a comprehensive information set from the DIPs is however not enough – it is crucial that these reports be effectively monitored, and that conflicts of interest be identified in a timely manner. For example, an automatic alert system that could flag conflicts of interest for members on Congress voting on specific bills could be a valuable improvement. Indeed, it would be very valuable that additional funding be provided to the *Observatorio* and other similar entities, as so to able continuously monitor progress in this area.

As for proposals regarding cross directorship and vote sterilization for those conglomerates that include banks and assigning the CMF and Central Bank explicit roles monitoring differential access to credit from these banks, it is important to carry out a more careful diagnosis to substantiate whether differential access to credit is present, before embarking on policy changes. This evaluation would necessarily consider all sources of funding for firms, including factoring, leasing, private debt and more recently crowdfunding and crowdlending.

The market studies that the *Fiscalía Nacional Económica* (FNE, the Chilean competition authority) can carry out would be a potential mechanism to analyse the relevance of this mechanism¹⁰. Previous FNE studies show that these reports are a powerful policy tool. One example is the FNE study on competition in the annuities market. This study proposed a series of regulatory changes to improve competition, of which all but one was latter included by the CMF in new regulation¹¹.

Before embarking on policies to limit conglomerates, it is also important to quantify the costs of doing so. As we mention above, internal capital markets may still play an efficiency role. In addition, there may also be economies of scale present in financial management functions, and transition costs may be also be important.

¹⁰ <https://www.fne.gob.cl/estudios-de-mercado/estudios/estudios-de-mercados-actuales/>

¹¹ The suggest changes to laws were included in pension reform bill sent to congress in the 2nd administration of President Piñera.

Regarding the cooling off periods discussed in the report – recent laws in Chile explicitly include cooling off periods and legal conflict of interest restrictions for incoming officials that had prior jobs in the private sector. This is the case of the CMF whose law that was passed in 2017.

However, the discussion of how best to design cooling off periods is not trivial. For institutions like the CMF, Central Bank or Finance Ministry cooling off periods would effectively close off a large share of private sector jobs. Hence, they should be remunerated so as not to limit candidates that have the required expertise for the positions. But in this they compete with scarce resources that could be spent on other public policies. Short cooling off periods are useful to limit use of insider information – but are likely less effective in avoiding preferential treatment by officials expecting future employment opportunities. As mentioned by the author, there is new evidence that shows that the cost could be larger than the benefit of these type of policies. (Lancieri et al., 2022)

Regarding changes in taxation, in particular the introduction of dividend tax as in the USA, we agree that this would be a strong disincentive to have conglomerate or pyramid structures because any movement of money between corporations will lead to additional taxes. However, there are several other issues that must be considered. First, in the USA large firms are subject to a disintegrated tax system where corporations are final contributors. It is standard in this type of tax system to have corporate and dividend taxes. Chile has a partially integrated system, where natural persons and foreigners are the only/main final contributors.¹² Dividend taxes are not logical in an integrated tax, except in those cases in which the tax dividend is a credit for final taxes. In this last case, the incentive to avoid conglomerate is drastically reduced. Second, it is important to note that in most other OECD countries with disintegrated systems, dividend taxes between corporation are smaller than for final contributor, or null. Finally, while the US dividend tax system indirectly influence ownership structures, it's not typically cited as one of their primary objectives.

An issue that report does not touch on but is extremely relevant in Chile is bank secrecy. Chile has gradually allowed supervisory institutions access to bank account data. A law currently in congress significantly expands access for the *Unidad de Analisis Financiero*, the Chilean financial crimes task force. A proposed tax reform facilitates the access, in real time, of the Internal Revenue Service (SII) to financial transactions. Supervising cash flows to detect tax avoidance and money laundering will also help to detect bribery.

¹² It could be considered that in the semi-integrated tax system corporation are 35% final contributor.

In the near future, we need to assess the impact of these reforms on competition and determine whether any adjustments or reinforcements are necessary. It is also important to expand powers of prudential regulation to financial conglomerates. In addition to “too big to fail concerns” firms in financial conglomerates can potentially carry out regulatory arbitrage, may rely excessively on shared resources (making resolution very complex) and are exposed to contagion from other members of the group. This would also force public disclosure of the structure of conglomerates to enhance market monitoring. The CMF currently has powers -granted by the financial stability law- to request information on the conglomerate for the supervision of regulated entities, it does not have legal powers to force public disclosure on conglomerate structure.

Finally, Chile has taken some important recent steps aimed at fostering competition in the financial sector. The recently approved Fintech law creates a level playing field between startups and traditional financial institutions. In addition, it sets up a regulated open finance system that should expand competition by reducing information asymmetries, reducing switching costs and facilitating innovation. The comprehensive credit registry recently approved by the Chilean congress will also reduce asymmetries and expand competition.