

Developments in the implementation of Basel III in the Chilean banking system

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Several regulatory innovations were introduced to the Chilean banking system with the enactment of Law No 21,130 on 12 January 2019. This law modernised the Chilean General Banking Act ('General Banking Act'). Some of the changes follow criteria based on the recommendations of the Basel Committee on Banking Supervision ('Basel III'). In particular, the following key legal changes were instituted, which have had or will continue to have an impact in the Chilean financial system:

- ▶ the transfer of all powers from the former regulator, the Superintendence of Banks and Financial Institutions, to the recently created Financial Market Commission (*Comisión para el Mercado Financiero*, or 'CMF'), which will also continue to be the regulator of the securities and insurance industries;
- ▶ the introduction of the concept of 'systemically important banks' (*Bancos de Importancia Sistémica*), giving the CMF the authority to request additional capital requirements for these institutions, subject to the terms and conditions in the General Banking Act;
- ▶ an update of the regulations on capital requirements following the recommendations of Basel III; and
- ▶ improvements to the mechanisms to deal with troubled banks before they become insolvent, the key objectives of which are the protection of depositors and taxpayers, the payment system and financial stability.

As of today, the transfer of powers to the CMF has been fully completed. Since June 2019, the authority for all matters related to banks and banking-related activities have been assumed by the CMF, whose main purpose is to supervise the proper operation, development and stability of the Chilean financial market (including banks), and to ensure that entities under its supervision comply with the laws, rules, bylaws and applicable regulations.

Improvements to the banking insolvency system have been fully incorporated in the General Banking Act, but we are yet to see how they will work when a Chilean bank faces insolvency, and other related issues. It may be noted that the former banking insolvency system, included in the General Banking Law prior to the 2019 reform, was never applied.

On the other two items (systemically important banks and new capital requirements), the Chilean regulator has been actively working with banks, the financial market and the public at large to address these key issues. The result of this has been the issuance of recent regulations that provide a clear regulatory framework to the Chilean financial institutions on how to satisfy the new requirements of the General Banking Act, as modified by Law No. 21,130. This is more fully discussed below.

Systemically important banks

Regarding 'systemically important banks', the CMF, after submitting a draft for comments to the market, issued on 2 November 2020 Rule 21-11 of its Updated Compendium of Banking Regulations (*Recopilación Actualizada de Normas*). This sets forth the elements and methodology to be taken into consideration for establishing whether a bank or group of banks may be considered as systemically important. Rule 21-11 also provides the additional capital requirements that may be imposed upon these institutions as a result of being considered as systemically important.

Although Rule 21-11 will enter into force in December 2020, and the first resolution by the CMF with a list of banks considered to be systemically important will be issued in March 2021, the additional capital requirements that may apply to such banks will become effective in stages, starting in December 2021 and ending in December 2025. This is an important feature of the regulation, which provides some flexibility to the system, allowing the relevant financial institutions to adapt over a period of time to the new capital requirements that may be imposed if they are considered as systemically important.

Rule 21-11 provides a broad definition of a systemically important bank. It indicates that a bank (or group of banks that belong to the same controlling entity) will be considered as 'systemically important' based on its relevance for the overall functioning of the Chilean financial system such that the financial deterioration or insolvency of that bank may have a material adverse impact on the rest of the financial system or even the country's economy as a whole.

Following the assessment methodology established by Basel III, Rule 21-11 qualifies banks as systemically important under an indicator-based system that considers the size, complexity, interconnectedness with other financial institutions and degree of substitutability of Chilean banks.

If a Chilean bank (or group of banks) is considered to be systemically important, then the CMF, with the prior consent of the Central Bank of Chile, will impose additional capital requirements on such bank within the limits set forth in the General Banking Act and Rule 21-11. If a systemically important Chilean bank is also considered as a 'global systemically important bank' by the Financial Stability Board, then the additional capital requirements will be the highest out of the local requirement, as determined by the CMF, and the global requirement as determined annually by the Financial Stability Board, which in no case may exceed the legal limit established in the General Banking Act of three and a half per cent.

Rule 21-11 provides that the process of determining if banks qualify as systemically important will be updated yearly, based on the information to be provided by such banks to the regulator related to the parameters considered in the indicator-based system described above.

New capital requirements

Regarding capital requirements, the General Banking Act, as amended by Law No. 21,130, introduced a new minimum regulatory capital or effective equity for banks, in line with Basel III, of at least eight per cent of risk-weighted assets. The minimum capital requirement, corresponding to the composition of assets with the best loss-absorbency capacity, was increased from four and a half per cent to six per cent of risk-weighted assets. This increase is achieved by incorporating an additional tier one capital requirement equivalent to one and a half per cent of risk-weighted assets, which the General Banking Act allows to be made up of preferred shares or bonds with no maturity (perpetual).

In order to provide specific rules to calculate the minimum regulatory capital or effective equity for banks, the CMF, after a period of public consultation, issued in October 2020 Rule 21-1 of its Updated Compendium of Banking Regulations. This sets forth the basic framework on this issue, including the regulatory adjustments and exclusions to the assets and liabilities items that need to be made to calculate the regulatory capital or effective equity of a bank.

Using the terminology proposed by Basel III, Rule 21-1 establishes that the effective equity or regulatory capital of a bank is composed of the following three tiers:

1. basic capital or common equity level one (CET1);
2. preferred shares and bonds with no specific maturity term (perpetual) or additional tier one capital (AT1); and
3. subordinated bonds and voluntary reserves, or tier two capital (T2).

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Rule 21-1 goes on to define each of these concepts and provides regulations on what exactly must be considered basic capital, additional tier one capital and tier two capital and how to calculate them to satisfy the capital requirements of the General Banking Act. It further gives a description of the regulatory adjustments and exclusions, including risk mitigators, which need to be applied over the basic capital of the bank.

The main driver of Rule 21-1 in calculating a bank's minimum regulatory capital or effective equity, as explained by the CMF, is to isolate or avoid any items that may be considered of low quality or uncertain economical value, or even hard to liquidate under financial stress conditions. The above measures have the purpose of allowing banks to have a more robust regulatory capital to deal with sudden or unexpected losses, thus strengthening and giving more stability to the financial system as a whole.

In line with the above, and to illustrate the point, Rule 21-1 provides for the total deduction of intangible assets, and the partial deduction of assets for deferred taxes and for certain reserves or profits when calculating basic capital. Likewise, Rule 21-1 sets forth certain prudential rules regarding concentration and the amount in which the non-controlling interest of a bank in other entities is recognised for the same purpose. Finally, Rule 21-1 does not include hybrid instruments issued by subsidiaries abroad as part of the consolidated effective equity.

Pursuant to its terms, Rule 21-1 will become effective in December 2020. However, regulatory adjustments and exclusions to the assets and liabilities, including risk mitigators, will be applied gradually, starting in December 2022 and ending in December 2025. On this date, all of the rules for calculating the basic capital of a bank will be fully in force. As with Rule 21-11, gradual application provides flexibility and allows banks to adapt over a certain period of time to the new capital requirements imposed by the General Banking Act and the CMF.

As reported by the CMF, and based on information as of 31 December 2019, it is estimated that the new calculation methodology established by Rule 21-1 will generate a decrease of approximately US\$2,300,000,000 or six and a half per cent in the effective equity or regulatory capital of the Chilean banking system. However, this does not necessarily imply that additional basic capital requirements will be imposed on Chilean banks, given that the final impact will depend on the methodologies used in determining risk-weighted assets.[1]

In conclusion

All in all, there have been important developments in the last few months in the implementation of Basel III in Chile. The enactment of Rule 21-1 and Rule 21-11 by the banking regulator has provided clear guidance on how two of the key regulatory innovations that were introduced by the General Banking Act, as amended in 2019 (ie, systemically important banks and the new capital requirement), will be put into place. These new rules follow the recommendations of the Basel Committee on Banking Supervision, therefore reflecting the best practices, protocols and regulations developed by global financial participants, but at the same time have been discussed and commented on by the relevant local financial entities, ensuring their applicability to the particular environment of the Chilean banking system.

[1] (file:///C:/Users/Gillian/AppData/Local/Microsoft/Windows/INetCache/Content.Outlook/RBD5BXEP/201119_Carey_Chile_CLEAN%20edit.docx#_ftnref1)http://www.cmfchile.cl/portal/prensa/604/w3-article-30056.html (http://www.cmfchile.cl/portal/prensa/604/w3-article-30056.html). Consulted: November 11, 2020.

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