



# Banking Regulation

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# Chile

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## Introduction

In January 2019, the deepest reform ever to the Chilean banking law came into force. The main purpose of this reform was to adapt Chile's banking law and other related regulations to the best practices, protocols and regulations developed by global financial participants. In a nutshell, the three main purposes of the reform were: (i) enhancing the banking regulator's corporate governance and regulatory authorities by consolidating all financial regulatory functions in a single entity, the recently created Financial Market Commission (*Comisión para el Mercado Financiero*, or “CMF”); (ii) bolstering the capital requirements of the banking system by adapting the existing regulations to the Basel III standards; and (iii) improving the mechanisms to prevent insolvency scenarios and to deal with institutions facing financial problems. All of these are referred to below. All of the above will, in our opinion, be an improvement to the banking system as a whole, creating a more attractive and competitive banking industry. In addition, given that the changes will materialise progressively, the impact on the general operation and functioning of the market and its members should be minor.

## Regulatory architecture: Overview of banking regulators and key regulations

### Regulators and key regulations

The CMF and, in some matters, the Central Bank of Chile (the “**Central Bank**”) are the main regulators of the banking industry.

The CMF was incorporated on February 23, 2017, by Law No. 21,000, and on June 1, 2019, it replaced and assumed, among others, the authorities of the former banking regulator: the Superintendence of Banks; and Financial Institutions.

The CMF's main mission (which is the basis for its regulations) is to supervise 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.

The Central Bank's main mission is to oversee the currency's stability and proper operation of internal and external payments.

The Chilean banking system is based on the General Banking Act of 1997. The General Banking Act was materially amended in January 2019, introducing several innovations on supervision, and adjusting banks' capital requirements and other obligations to the standards set out in Basel III.

Since banks must be incorporated as special corporations, Law No. 18,046 (“**Corporations Act**”) also applies to banks (with certain exceptions), mainly regarding corporate governance. In addition to the above, both regulators have enacted several regulations, of which the most important are:

- CMF: Updated Compilation of Rules (*Recopilación Actualizada de Normas*) issued by its predecessor (i.e. the Superintendence of Banks and Financial Institutions).
- Central Bank: Compendium of Financial Regulations.

#### Restrictions to the activities of banks

Only entities authorised under the General Banking Act can perform core banking activities in Chile. Financial activities that are not regarded as core banking activities are permitted without a banking licence (for example, lending, financial advice (not intermediation) and derivative transactions).

Banking services are understood generally as receiving, in a customary manner, money or funds from the public, to use it to grant loans, discount documents, make investments and perform financial intermediation, while obtaining revenue out of this money and performing related activities permitted by law.

Article 69 of the General Banking Act lists the operations banks can engage in, which include (among others):

1. Deposit-taking and accepting other repayable funds from the public.
2. Issuing bonds or debentures.
3. Lending (in its various forms).
4. Money brokerage, intermediation or brokerage of trading and debt instruments.
5. Issuing letters of credit and performance bonds.
6. Entering into derivative transactions, money collection, payment and transmission services.
7. Trading money market instruments, foreign exchange, financial futures and options, exchange and interest instruments.
8. Acquisition, sale and trading of debt or fixed income instruments, and providing underwriting services related to the issue and placement of such securities, and acting as a placement agent and underwriter relating to offerings of newly issued shares of the stock of public corporations.

Under Article 70 *et seq.* of the General Banking Act, banks are authorised to incorporate subsidiaries to perform the following operations or activities:

- Stockbrokerage, broker-dealers, management of mutual funds, investment funds or foreign capital investment funds, securitisation and insurance brokerage.
- Leasing, factoring, financial advice, custody and transport of securities services, credit collection services and other financial services which the CMF, by a general ruling, deems ancillary to the banking business. Banks are also authorised to set up subsidiaries in the real estate business and managers of housing funds.

Additionally, banks are allowed, with prior CMF authorisation, to be shareholders or participate in banking support companies (*sociedades de apoyo al giro bancario*). These are companies whose sole objective is providing services to facilitate compliance with bank purposes, and/or carrying out some banking activity other than raising money. Once the CMF has granted authorisation to a bank to incorporate or participate in a banking support company, the CMF cannot deny the same authorisation to another bank.

## Recent regulatory themes and key regulatory developments in Chile

On January 12, 2019, Law No. 21,130, which modernised the banking legislation, was enacted, introducing the following key regulatory developments:

- (i) it transferred all powers from the former regulator, the Superintendence of Banks and Financial Institutions, to the CMF;
- (ii) following the recommendations of Basel III, it updated the current regulations on banking capital requirements and risk management;
- (iii) it introduced the concept of “Systemically Important Banks” (*Bancos de Importancia Sistémica*) and empowered the CMF to request additional capital requirements for these institutions, subject to the terms and conditions in the General Banking Act; and
- (iv) it improved previous 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.

For further details, please refer to our relevant news alert at: <https://www.carey.cl/en/law-21130-modernizes-chilean-banking-legislation/>.

## Bank governance and internal controls

### Governance and risk management

Banks in Chile must be incorporated as corporations, following the specific requirements in the General Banking Act and the Corporations Act. Every bank in Chile must be a special corporation (*sociedad anónima especial*) under the specific requirements of the General Banking Act.

Under the General Banking Act, the main body is the board of directors, entrusted with the direction of the bank and proper risk management. Directors cannot be both directors and employees of the bank.

The internal organisation of banks is mostly carried out by the board of directors which must provide necessary governance of the banking entity through senior management, committees and policies.

All directors must fulfil several honourability and solvency requirements to be appointed as such. These requirements include not: being convicted of serious crimes described in the General Banking Act; being sanctioned by infringements to market regulations; having incurred in serious conducts that may risk the bank’s stability or the safety of its depositors. It is forbidden by law to set special requirements based on nationality or profession for the appointment of a bank director, and notwithstanding the fulfilment of the abovementioned conditions, there are neither specific approvals from regulators nor certifications required in this regard.

The board must adopt necessary measures to remain informed of the management and general situation of the bank. The board must have at least five members and a maximum of 11 and must always be composed of an odd number of directors. The directors remain in office for three years and can be re-elected. The board must meet once a month.

Sound internal governance is measured in accordance to the CMF’s Guide to the Banking Supervision Process. Pursuant to this Guide, the main objective of banking supervision is assessing the quality of risk management used by banks. This approach, according to the CMF, corresponds to a Supervision Based on Risks (“SBR”) approach, which reflects the maturity of the banking industry in Chile.

According to the Guide to the Banking Supervision Process, SBR is based on the following pillars that set standards for choosing persons with control functions, based on the levels of technical knowledge required:

- Government and supervision. The board of directors and the banks' committees must strongly promote the risk policy, requiring and receiving information to correctly assess the risks and apply agreements reached.
- Risk management framework. A clear demarcation of the policies and procedures decided by the board, which must be consistent with the bank's volume of business.
- Measurement and continuous monitoring of risk. This in turn includes:
  - risk quantification: review and evaluation of the bank's risk assessment methodologies, to determine if these are duly documented, updated and consistent with the business depth and volume;
  - timely follow-up of risk: early warnings (constantly reviewed under established protocols) for risk detection and boundaries that limit the risks, with necessary analysis and bases for it;
  - risk information system: involving a management report structure, this must address the needs of the bank's different levels; and
  - independent review: internal independent and qualified auditing, with adequate depth and coverage. Its analysis approach should consider risk, compliance with internal policies and regulations, obtaining a recognised and validated opinion by different levels of the bank, and appropriate technological tools for developing their work.

### Internal control

Chapter 1-13 of the Updated Compilation of Rules (*Recopilación Actualizada de Normas*) of the CMF defines corporate governance as a set of institutional instances, guidelines and practices that influence the bank's decision-making process, contributing, among other things, to the sustainable creation of value, within a framework of transparency and adequate management and control of risk. It classifies the banks according to their organisational rules as level A, B or C, with A being the most compliant with management proceedings.

The following aspects, among others, are considered by the CMF as inherent to good corporate governance and criteria for evaluating a bank's management:

- i. Establishing strategic objectives, corporate values, lines of responsibility, monitoring and accountability.
- ii. Verifying the performance of senior management and compliance with policies established by the board of directors.
- iii. Promoting sound internal controls and effective audit.
- iv. Establishing proper disclosure mechanisms.

### Outsourcing of functions

Banks in Chile are allowed to outsource certain functions, provided the requirements set forth by the CMF are complied with. Chapter 20-7 of the Updated Compilation of Rules (*Recopilación Actualizada de Normas*) of the CMF contains the rules applicable to outsourcing of functions. Certain activities of banks may under no circumstances be outsourced, such as: those related to raising funds from third parties outside the bank's offices; the opening of bank accounts; and functions related to internal controls of the banks.

Banks are required to assess all the risks associated with outsourcing functions and establish an outsourcing policy that appropriately addresses those risks, including a proper governance structure, a sound framework of applicable regulations and procedures and an environment that allows the identification, control, mitigation, monitoring and reporting of such risks.

Any outsourcing policy should consider, in general, the following elements: (i) general conditions approved by the board of directors regulating the activities or functions that may

be outsourced; (ii) continuity of business; (iii) safety of the bank's own information and that of its clients; (iv) observance of banking secrecy; and (v) the political risk (*riesgo país*) of the country where the service provider is located (with banks not being allowed, except under certain exceptions, to outsource services to companies located in a country that does not have an investment grade), etc.

### Bank capital requirements

Following the recommendations of Basel III, the current regulations on capital requirements were updated by the abovementioned Law No. 21,130, which increased such requirements from both a quantitative and qualitative point of view to address the risks currently associated with banking activity. The main innovations in this regard can be summarised as follows:

1. **Capital requirement.** The minimum required level of effective equity is 8% of risk-weighted assets. The Tier 1 minimum capital requirement, corresponding to the composition of assets with the best loss-absorbency capacity, was increased from 4.5% to 6% of risk-weighted assets. This increase is achieved by incorporating an additional Tier 1 capital requirement equivalent to 1.5% of risk-weighted assets. Additional Tier 1 capital can be made up of preferred shares or bonds with no maturity (perpetual).
2. **Conservation buffer.** A conservation buffer of 2.5% of risk-weighted assets above the established minimum must be set, which must be made up of basic capital.
3. **Additional basic capital.** Supplementing this conservation buffer, the law incorporates an additional basic capital requirement of a countercyclical nature, which will be generally applicable to all banking companies incorporated or authorised to operate in the country, by means of which it seeks to mitigate the development of systemic risks. The Central Bank, depending on the phase of the economic cycle, can set this reserve at up to 2.5% of the risk-weighted assets, subject to the consent of the CMF.
4. **CMF authorities.** Additionally, the CMF is granted the authority to require basic capital or additional effective equity for up to 4% of the risk-weighted assets in those cases in which the legal requirements are not sufficient to cover the specific risks faced by a determined entity.

### Banking liquidity requirements:

Article 35 No. 6 of Law 18,840, the organic constitutional law of the Central Bank, empowers it to enact regulations and set restrictions applicable to the relationships between active and passive banking activities.

Based on the above, the Central Bank enacted Chapter III.B.2.1 of its Compendium of Financial Regulations, which sets rules on the management and measuring of banks' liquidity positions. Even though local banks solidly endured the global financial crisis, the Central Bank introduced this rule to prevent future liquidity shocks.

In this regulation, the Central Bank has established minimum standards and requirements that shall be observed by banks with the purpose of maintaining an adequate liquidity position, in both local and foreign currency, that allow banks to properly fulfil their payment obligations in both regular conditions and in exceptional stress scenarios, the occurrence of which can be considered as plausible.

Chapter III.B.2.1 states that the board of directors is responsible for setting the bank's liquidity risk tolerance, understood as the liquidity risk level that the relevant bank is willing to assume as a result of both the risk/return assessment of its global policies, and the manner as to which such risks are managed. For these purposes, the board of directors must adopt, lead and oversee the implementation of a liquidity management policy (*Política de Administración de*



*Liquidez*, “PAL”). The bank’s senior management is responsible for proposing to the board the liquidity management policies compatible with the nature, scale and complexity of the business and risk tolerance of the bank, enforcing and updating the PAL.

The PAL must contain stress tests, which must be performed at least quarterly, considering the structure of the bank’s assets and liabilities, the scale and complexity of its operations, and possible effects on its cash flow and liquidity position. The PAL must also establish a formal contingency plan, setting the strategies to be adopted when facing a liquidity deficit in stress scenarios.

Under Chapter III.B.2.1 of the Central Bank Act’s Compendium of Financial Regulations, the liquidity position is measured through the difference between expenses and income flows in and out of the balance sheet, for a given period. This difference is called a “term mismatch”.

Banks must observe the following limits regarding term mismatches:

- The sum of all term mismatches for up to 30 days cannot exceed the basic capital.
- The same requirement must be met considering only flows in foreign currency.
- The sum of the term mismatches of up to 90 days cannot exceed twice the basic capital.
- Therefore, projected net cash outflows in 30 days cannot be higher than the equity capital of the bank, and projected net outflows in 90 days cannot surpass twice that amount.

The PAL shall be available at all times for CMF review.

Term mismatches, if any, must be reported by the bank to the CMF.

### **Rules governing banks’ relationships with their customers and other third parties**

In their relationship with clients, the general rules applicable to each type of banking activity will apply. Therefore, banks need to follow the rules contained in Law No. 18,010 (“**Money Lending Operations Act**”) that govern the lending business in Chile, setting out what is understood as a money lending transaction, the rules governing accrual of interests and other matters (including maximum interest rate (*interés máximo convencional*)), the Consumer Protection Act (Law No. 19,496), and the Data Protection Act.

In addition, there are specific rules that govern the relationship of banks with their customers. Most of these specific rules are contained in sectorial regulations enacted by the CMF, such as those regarding bank hours, bank accounts, leasing and factoring operations, other banking operations, issuance of subordinated loans, etc. Banks are also required to observe lending-limits regulations when dealing with customers.

Anti-money laundering regulations are also applicable in the relationship of banks with customers. In fact, banks need to follow Law No. 19,913 (“**Anti-Money Laundering Act**”) that sets forth the general framework on anti-money laundering. In particular, banks are required to report to the Financial Analysis Unit (*Unidad de Análisis Financiero*) (“**UAF**”):

1. “Suspicious transactions” they are aware of.
2. Cash transactions exceeding US\$10,000, on a semi-annual basis.
3. Documents and antecedents it requires to examine a previously reported suspicious transaction, or one it has detected.

Law No. 20,393 extends to legal entities liability for criminal wrongdoings related to money laundering, financing terrorism and bribery of civil servants (if such crimes are committed directly and immediately in the legal entity’s interest or for its benefit, by its owners or controllers).

The CMF requires banks, in addition to following the rules set forth in the Anti-Money Laundering Act, to have specific anti-money laundering systems in place, which are based



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on the “know-your-customer” system. Chapter 1–14 of the Updated Compilation of Rules (*Recopilación Actualizada de Normas*) of the CMF contains the main features that every bank’s “know-your-customer” system should contain.

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