

Chilean banking law reform: three key aspects

September 2018 | PROFESSIONAL INSIGHT | BANKING & FINANCE

Financier Worldwide Magazine

There is consensus that Chile was able to endure the 2008 global financial crisis and avoid the serious impact and effects it had in other emerging countries thanks to the strength of its banking industry.

The Chilean General Banking Act (GBA), heavily modified in 1986 as a consequence of the country's 1982 financial crisis, laid out the basis for the banking sector to steadily develop and grow over the last 30 years, while at the same time setting forth clear rules and principles to avoid systemic risk and over lending, and to keep safe levels of liquidity.

In particular, and although Chile did not adopt Basel II, the GBA has, since 1986, required a regulatory capital of at least 8 percent of risk-weighted assets at all times, equivalent to standard capital requirements under Basel III. However, it does not contemplate Tier 2 capital and the new Additional Tier 1 (AT1) feature of Basel III. The banking regulator, the *Superintendencia de Bancos e Instituciones Financieras* (SBIF), has had an active involvement in the development and growth of the Chilean banking industry and in the issuance of the sound rules and principles it has been governed by.

However, the increasing internationalisation of the Chilean banking industry, the relevant local presence of foreign banks and the aim to meet international financial standards, have shown the need to adapt the GBA and other banking regulations to best global practices. In June 2017, the Chilean government submitted to Congress a bill to amend the GBA and discussions have been ongoing for the past year. It is expected that the amendments to the GBA will be approved by



September 2018
Issue

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Congress and will become law by the end of 2018.

There are three main purposes of the amendment bill: (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 or *Comisión para el Mercado Financiero* (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.

One regulator

On 23 February 2017, Law No. 21,000 was published in the Official Gazette of Chile, creating the CMF, which became fully operational in January 2018. The creation of the CMF had long been sought by the Chilean financial market due to the need for a regulatory body with improved corporate governance, comparable to that of regulators in developed markets, with greater and more effective control and specific administrative sanctioning regimes. Upon the enactment of the amendments to the GBA, and after satisfaction of the further conditions or terms that may be set forth therein, the CMF will assume the duties of the SBIF, and will consolidate all regulatory and supervisory functions of the financial market. There is no doubt that this consolidation will help to ensure the proper functioning, development and stability of the Chilean financial and banking markets, facilitating the participation of market agents (including banks) and promoting appropriate market-wide standards. Furthermore, it will also ensure that regulated persons or entities comply with laws, regulations, statutes and other provisions governing them, while at the same time facilitating legal coordination, coherence and compatibility of the whole system.

Some players, however, have raised concerns that concentrating all the regulatory and supervisory authorities of the financial market in a single entity, such as the CMF, may reduce predictability and flexibility compared to the current regulatory behaviour of the SBIF, which, as an exclusive regulator of the banking system, is known to be a conservative and dedicated regulator, industry-oriented and committed to encouraging smooth and non-disruptive changes to the system, when needed.

The transition from an industry-focused regulator to a consolidated one, having overall responsibility for the financial markets will, in our opinion, be an improvement to the system as a whole. Further, given that the changes will materialise progressively, the impact on the general operation and functioning of the market and its members should be minor.

New capital standards: Basel III

Basel III capital standards may represent the major challenge for Chilean banks under the new GBA. Currently, the GBA requires banks to have a regulatory capital of at least 8 percent of risk-weighted

assets at all times, which is comparable to standard capital requirements under Basel III (with a basic capital of 4.5 percent of risk-weighted assets and a regulatory capital that increases to an aggregate of 8 percent of risk-weighted assets). However, in line with Basel III, the new GBA will require banks to have an AT1 capital of up to 1.5 percent, thus increasing the Tier 1 basic capital to 6 percent, and a Tier 2 capital and a conservation buffer (*colchón de conservación*), increasing the total capital requirement to 10.5 percent of risk-weighted assets. Additionally, the new GBA contemplates a countercyclical cushion and extra capital contributions for banks that may be considered as systemically important financial institutions by regulators.

Once the amendment is enacted, banks will have a six-year term to comply with the new capital requirements set forth in the GBA. Preliminary estimates by the SBIF indicate that the gap between current levels of capital and those to be achieved under the Basel III-inspired amendment to the GBA is around US\$2.8bn. Others, however, have estimated the gap to be as high as US\$4bn. This is a sizable gap that will need to be filled.

The use of AT1 instruments, which will be allowed by the reformed GBA, will certainly help local banks to reach the new capital standards, but some practical issues still need to be addressed in order to allow these new instruments to be useful. In fact, the reform bill contemplates the issuance by local banks of preferred shares or bonds with no specific maturity term, subject to the requirements set forth therein, and to the additional terms and conditions to be established by the regulator. These are totally new types of securities in the Chilean market and the behaviour of banks and investors toward them is yet to be seen.

Additionally, the methodology to be adopted by the regulator for calculating risk-weighted assets may further impact (for better or worse) the capitalisation of banks and their ability to satisfy the new capital standards. Currently, the GBA considers only credit risk to determine risk-weighted assets and the SBIF has established strict and conservative methods for making the relevant calculations. The reformed GBA, however, has added market and operational risks for the determination of risk-weighted assets, and gives discretion to the regulator, with the prior agreement of the Chilean Central Bank, to establish standardised calculation methodologies. The SBIF has indicated that this will provide flexibility to the system, allowing it to adapt the regulations to new, future standards without the need for legal reform. However, until the new methodologies have been passed, the impact on capitalisation cannot be determined.

It is worth noting, in any case, that, as informed by the SBIF by the end of July 2018, the banking industry declared profits for the first half of 2018 of approximately US\$2bn, a 2.71 percent year-on-year increase, evidence of the strength of the financial sector in Chile and that the capitalisation gap that will be created when the new capital standards become effective under the reformed GBA may not be as difficult to fill as may seem.

Banking resolution

Finally, the reform of the GBA aims to provide flexibility to the banking industry, by improving the mechanisms to deal with institutions facing financial problems and prevent insolvency scenarios. The idea, basically, is the early identification of solvency, liquidity or management problems that a financial institution may be dealing with, and addressing them in their initial stages to avoid potential liquidation and major damage to the system as a whole.

As currently drafted, the amendment bill will require a financial institution facing a solvency, liquidity or management problem to prepare and submit a regularisation plan, approved by its board of directors, specifying the actions to be taken in order to overcome any of the problems being faced by the bank and allowing it to ensure normal operations will continue.

In supervising compliance of the regularisation plan, the regulator will have a wide range of authorities (including appointing a provisional manager, limiting banking activities, requesting additional capital contributions, and so on) over the relevant bank, in order to achieve an orderly regularisation and prevent a crisis scenario.

This is a big departure from the current GBA, where liquidation is the only option if the solvency of the bank is not rapidly regularised in the manner required by the GBA.

All in all, the GBA proved to be a decisive and dynamic mechanism that created a regulatory and business environment that allowed the Chilean banking system to constantly expand and evolve since 1986, with solid rules and guidelines that have encouraged banks to act in a conservative manner, avoided over lending, kept appropriate liquidity levels and mitigated overall systemic risk. Yet, this constant expansion and evolution, which brought with it the internationalisation of the Chilean banking industry, clearly showed the need to modernise the fundamental rules governing the banking sector and to conform them to the best practices, protocols and regulations developed by global financial participants. The reform to the GBA currently being discussed in the Chilean Congress constitutes the materialisation of this modernisation need, with the three aspects described in this article being key to showing how our regulations are accommodating and adjusting to international standards.

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