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International Briefings

Chile

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MIND THE GAP: BASEL III AND ITS IMPLEMENTATION IN CHILE

This article briefly describes some of the issues Chilean banks and financial supervisory authorities are facing with regard to the implementation of new capital requirements set forth by Basel III. The implementation of this global regulatory framework calls for the most important reform to the Chilean General Banking Act (GBA) in almost 30 years, and has placed hybrid securities on the agenda.

BASEL III'S NEW CAPITAL REQUIREMENTS

Chile is one of the few countries that endured the last global financial crisis, and emerged with a solid and stable economy, mainly due to the strength of its banking sector. Conservative Chilean banks and their zealous authorities learned the lessons from the country's financial crisis in 1982; since then, they have carefully avoided systemic risk, over lending and have kept safe levels of liquidity. Additionally, the Chilean banking industry has grown steadily for the last 30 years. Chile did not adopt Basel II, but the GBA already provided for (and still does) a regulatory capital of at least 8% of risk-weighted assets at all times, equivalent to standard capital requirements under Basel III. Regulatory capital under the GBA is almost entirely comprised of equity and undistributed revenue. However, it does not contemplate Tier 2 capital and the new Additional Tier 1 (AT1) feature of Basel III. AT1 is introduced by Basel III as a new high quality capital base intended to strengthen banks' positions when facing risk exposure. As such, the instruments qualifying for AT1 are required to contain certain special features which limit their availability in certain markets. AT1, together with the counter-cyclical buffer, can be considered the most relevant changes from Basel II regarding capital requirements.

BASEL III IN CHILE

The Chilean government is undertaking a major reform of the GBA in order to comply with Basel III's requirements. The motivation for the reform is the internationalisation of the Chilean banking sector, the increasing local presence of foreign banks and the aim to meet international financial standards. One aspect of this reform is the inclusion of AT1. Preliminary estimates by the banking industry indicate that the gap between current levels of capital and those to be achieved under Basel III is around US$4bn. This is a considerable amount which needs to be met by either equity or instruments that meet the criteria to be included in AT1. Bearing this in mind, the industry has begun to analyse the legal framework and the potential amendments required for these instruments to exist in Chile.

AT1 INSTRUMENTS: LEGAL ISSUES

The discretionary character of AT1 instruments and the ability of banks to use these instruments to overcome sudden liquidity crises is essential for Basel III. Some of the main criteria to qualify as an AT1 instrument under Basel III are that:

- the instruments are subordinated to depositors, general creditors and the subordinated debt of the bank;
- they are unsecured;
- they are perpetual (no maturity date or incentives to redeem);
- the instruments may be callable at the sole initiative of the issuer after five years but with prior supervisory approval, among other requirements;
- repayments (eg through repurchase or redemption) should be made with prior supervisory approval;
- with regard to dividends or coupons:
  - banks must have full discretion to cancel these payments;
  - discretionary cancellation must not be an event of default;
  - banks must have full access to cancelled payments to meet obligations as they fall due;
  - cancellation of dividends or coupons must not result in any restrictions on the bank, except that the bank cannot distribute dividends to common stockholders; and
- payments must be paid out of distributable reserves.

We will focus on three topics from this list:

- the perpetuity of the instruments;
- dividend/coupon payment discretion; and
- equity-like behaviour (particularly the non-distribution to common stockholders when cancellation takes place).

NOTHING LASTS FOREVER

Perpetuity of debt instruments is an issue in Chile. Under the Chilean Securities Market Law (SML), the public offering of debt securities with terms longer than one year must be made through bonds and subject to the provisions of the SML. For banks, the SML states that banks and financial institutions will not be subject to its rules, and, if authorised by their applicable regulations to issue bonds, must do so under those rules and subject to the supervision of the Banks and Financial Institutions Commission (*Superintendencia de Bancos e Instituciones Financieras*, (SBIF)).

Although the GBA addresses the issuance of bonds by banks, and deals with subordinated debt issuances and procedures, there are no other relevant provisions. Further, neither the SML nor the GBA define 'bonds' either on a legal or regulatory basis. How then can regulators determine what hybrid features if any, can be included in a bond? Can bonds be perpetual? What are the limits? Going back to basics, the Chilean Civil Code states that the term of an obligation is the time chosen for its fulfilment either by the law, the parties or by the nature of the obligation itself. It also states that the tacit or implicit term is that considered indispensable to fulfil the obligation. The law is silent, however, with regard to termless or perpetual obligations. If we simplify the concept of a bond (which as mentioned above, is not expressly defined under Chilean law) and include it within the traditional definition of a money credit operation, it would comprise an operation by which one party provides funds to another party, the latter which assumes the obligation to pay back those funds in the future. In the case of hybrid instruments with equity features, principal will not be paid at all, unless the instrument is redeemed. Chilean companies have tried to issue perpetual debt instruments in the past, but these issuances have been discarded by the authorities based on the argument that inserting "perpetual" in the section related to "Term" on the requisite form is not acceptable as the concept of a perpetual term is not recognised.

PLAYING IT SAFE

Insurance companies and pension funds, as the largest institutional investors in the country, are the natural target for hybrid instruments. However, the discretion whether to make a payment under hybrid securities is an unattractive feature for Chilean investors, especially institutional ones. AT1 hybrids have performed well in other markets to date, but the Chilean market remains sceptical about its implementation, extending a long shadow over hybrids' future. Risk rating agencies are rating the hybrid debt up to five notches higher than the issuer's credit rating which is not helping matters.The Chilean pension system is based on mandatory savings deducted from employees' salaries. This money is channelled through to different funds depending on the age and risk profile of the employee. The funds are managed and invested by heavily regulated private management entities (*Administradoras de Fondos de Pensiones*, or "AFP"). AFPs and the entire pension system are currently under intense scrutiny from the public, and investing in instruments for which payment (and yield) can be cancelled at the discretion of the issuer is not an attractive prospect as it creates a higher level of risk when dealing with employee's retirement funds. Insurance companies are heavily regulated too. The Decree with Force of Law No 251 (Insurance Law) provides that insurance companies must back up their technical reserves and equity using specific instruments and assets, which include bonds and other debt instruments. However, the concept of bonds is not defined here either, and AT1 hybrids do not meet the criteria. In this industry, companies are regarded as conservative and not willing to invest without a clear return. Selling payment discretion to these 'natural' buyers will prove to be a formidable challenge for market arrangers, financial advisors and Basel III's promoters.

DIVIDENDS DISTRIBUTION

Basel III imposes two requirements that are a cause of concern for banks' shareholders, and could require specific exemptions: (i) the ability to cancel payments can be exercised by the issuer without imposing restrictions on the issuer, other than on the distribution of dividends to its shareholders; and (ii) payments to holders of hybrid instruments must be made from distributable funds.

In Chile, banks must be incorporated as "special corporations". This subjects them to the Corporations Law (CL), with certain specific exceptions. The CL states that unless otherwise agreed in an extraordinary shareholders' meeting by a unanimous vote of all the shareholders, corporations must distribute at least 30% of their net profits annually. The GBA forbids, as does Basel III, distributions of dividends if as a result of the distribution the minimum regulatory capital is affected. Additionally, banks as corporations subject to the CL, are required to distribute minimum dividends.

Accordingly, no payment on a hybrid instrument can be cancelled if there are distributable profits at the bank, unless all of the bank's shareholders agree to waive their right to receive their minimum mandatory dividends in a given year. Even in highly concentrated banks, it would be difficult to align the interests of all minority shareholders to secure their consent when they are less concerned with diluting their shareholding and more interested in obtaining a return on their investment. Rather than accepting hybrid instruments, shareholders will most likely demand that additional equity be brought in by the controlling entities and majority shareholders.

WHAT NOW?

The implementation of Basel III is on its way, and even though the SBIF's commissioner has clarified that Chile is not adopting Basel III, but *adapting* it, a tremendous effort will still be required from a regulatory, financial and market standpoint in order to successfully implement the required changes.

All parties involved should take advantage of the unique momentum that is currently active in Chile. The SBIF, the GBA and the Securities and Insurance Commission (Superintendencia de Valores y Seguros) are being modernised, and the country is energetically promoting investments and strengthening its financial sector in order to overcome the consequences of the global financial crisis, low copper prices and the implementation of numerous political reforms that have affected the country's growth. Fulfilling local expectations and at the same time meeting international standards represents a challenge for the financial authorities and industry.

There are a number of difficult issues that must be discussed, adapted, enhanced and possibly discarded in order to move forward, and all stakeholders must work together to find innovative solutions to allow them to overcome these obstacles and move the country to the forefront in hybrid instruments. ■