Banking Regulation and Supervision in Chile: Issues on the Reform Agenda

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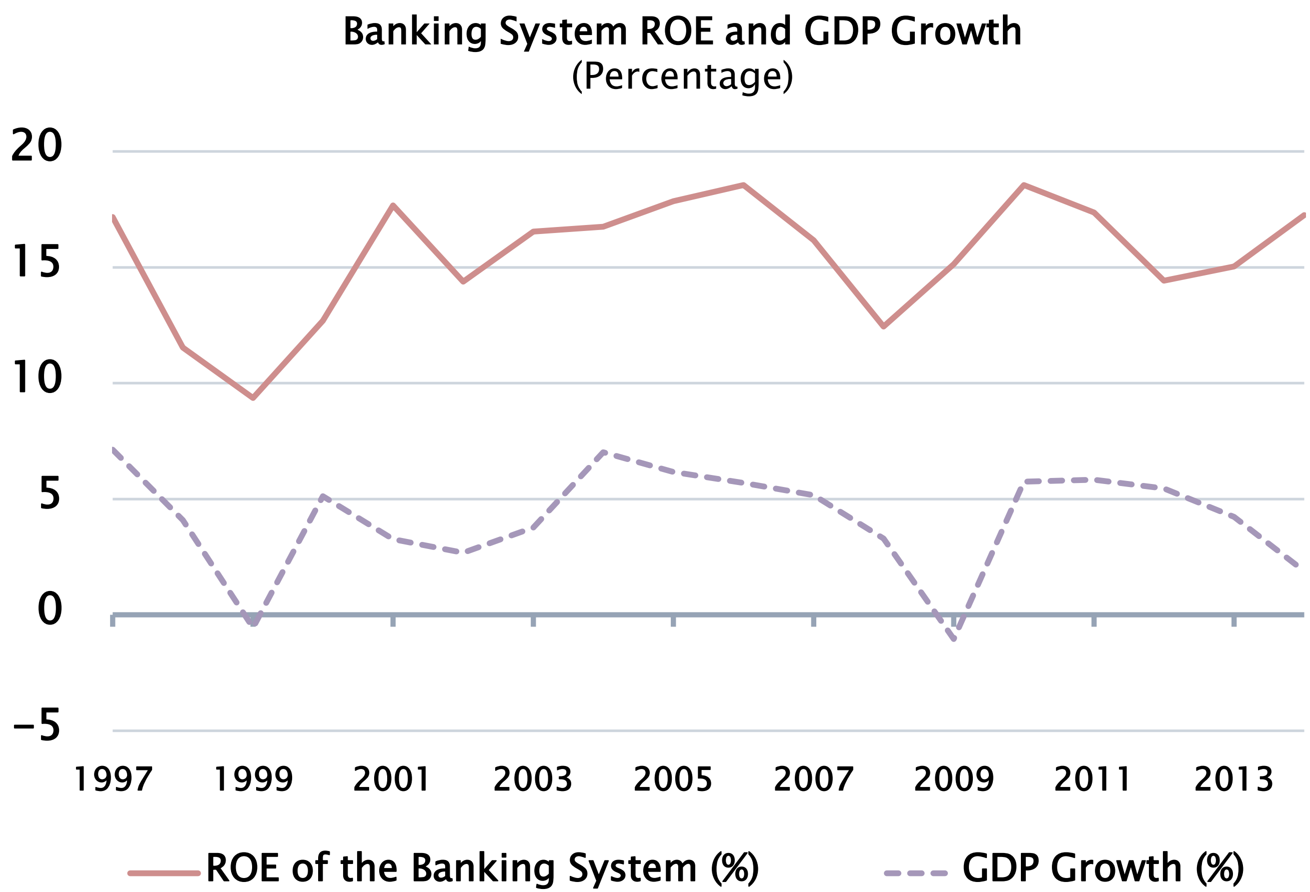
Chile's banking system has shown a high level of stability over the last 2 or 3 decades.

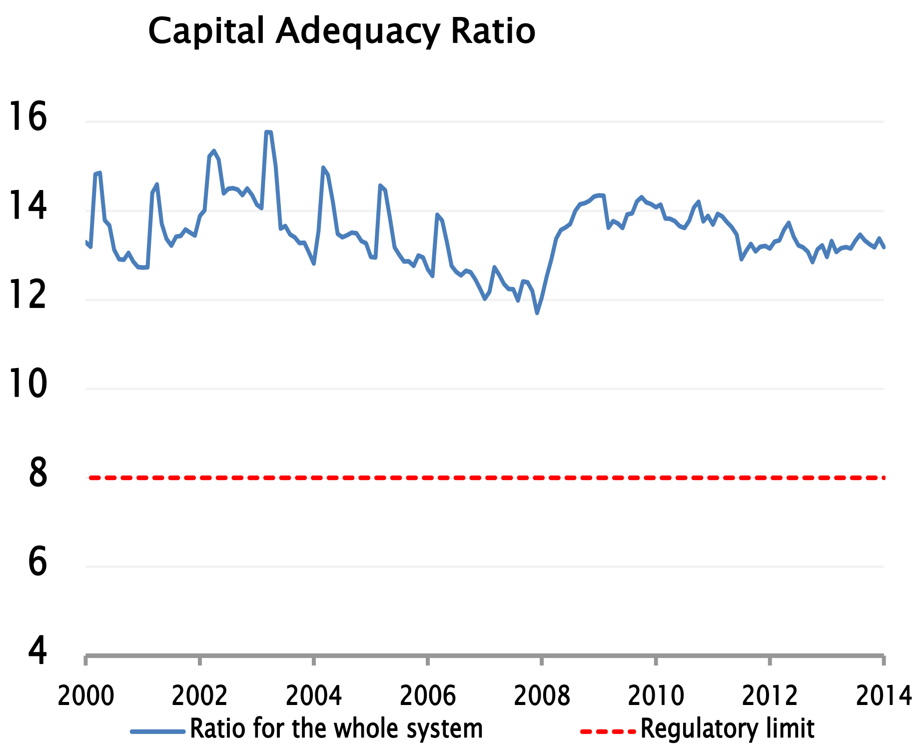
- The last major crisis occurred in 1983 as part of the Latin America debt crisis.
- In more recent times, it has been able to overcome stressing episodes like the Asian crisis in late 90s and the global financial crisis in 2008/9 with no significant disruptions.
- Several indicators confirm this view.

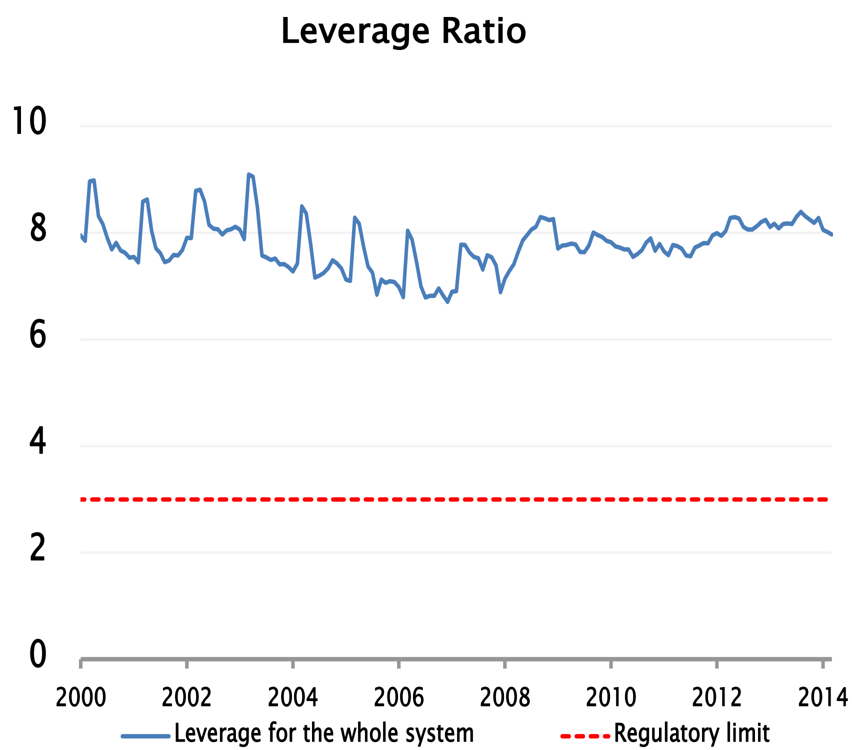
Return on equity has remained high on average, although it has been sensitive to changes in macroeconomic conditions.



Source: Superintendence of Banks and Financial Institutions, and Central Bank of Chile.

Solvency has remained solid and stable over time as measured by either the capital adequacy ratio or the traditional leverage ratio.





Source: Superintendence of Banks and Financial Institutions.

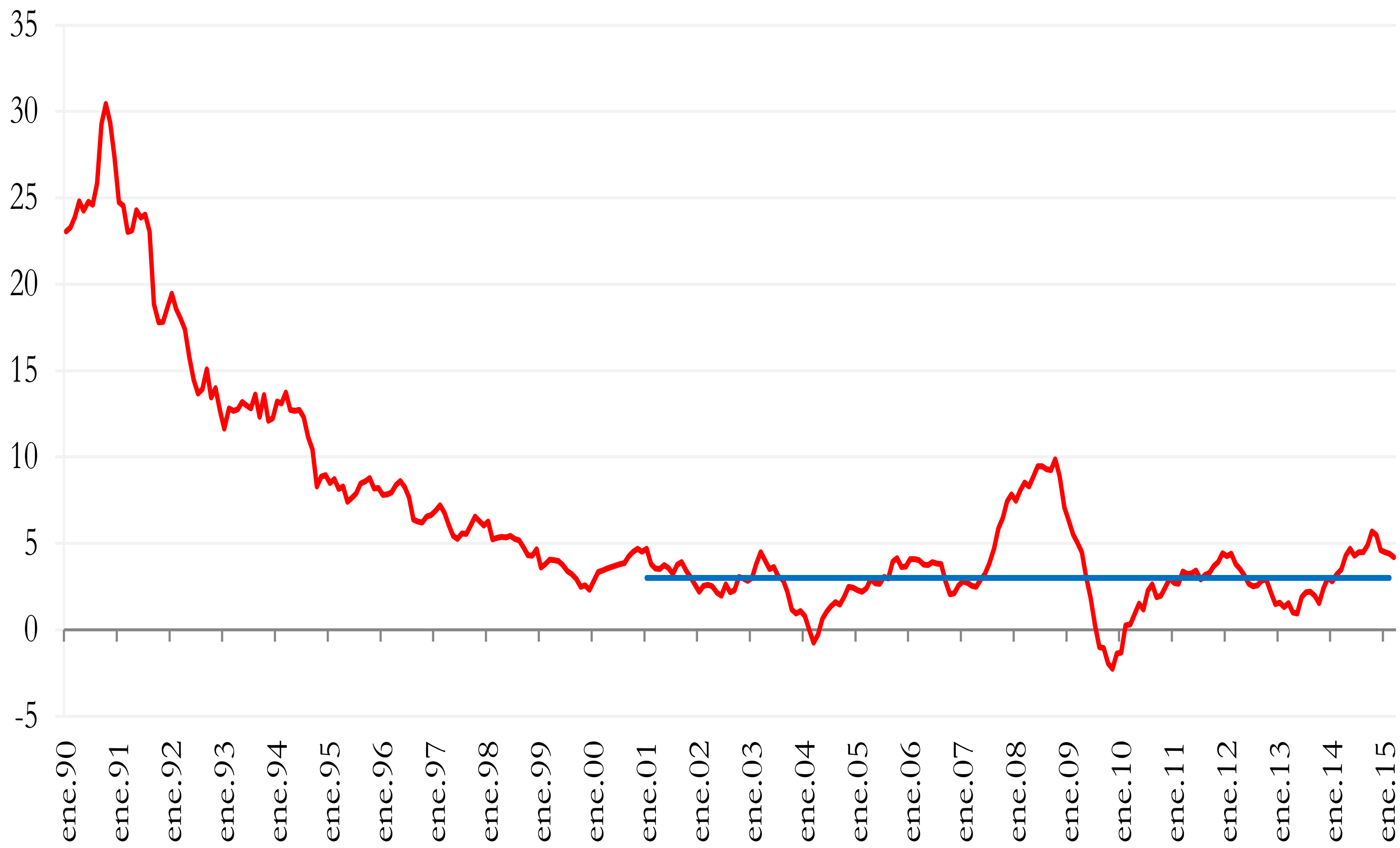
It has to be recognized that Chile's macroeconomic policy framework has made a significant contribution to financial stability. Pillars of this policy framework include:

- A monetary policy being conducted by an autonomous Central Bank.
- A responsible and predictable fiscal policy.
- A floating exchange rate regime.
- Increasing commercial and financial integration with international markets.

Monetary policy has been successful in keeping inflation under control.

- Inflation is no longer the problem it was in the past.
- Starting in 2001, the Central Bank put in place an inflation targeting regime and set the target at 3%. This has proven to be an effective policy option.
- Of course inflation has not always remained at the level of 3%. It has fluctuated over time for different factors, most of which were not controlled by the Central Bank.

However, the average annual rate for the whole period during which this regime has been under application is close to or slightly above 3%, which is a quite satisfactory performance.



For the last 15 years, fiscal policy has followed a formal rule that set limits to fiscal expansion.

- Each new administration set a formal target for the entire presidential period.
- The current target is to reach a 0% deficit by the end of this administration.
- As a result, the ratio of public debt to GDP has remained bounded.

A floating exchange rate regime allows for flexible adjustments to exogenous shocks, as shown in the 2008/9 and 2013/14 episodes.

i. The Central Bank does not intervene in the market.
ii. However, it retains the power to do so in exceptional cases.
iii. This policy regime makes a difference in relation with other emerging economies, where foreign exchange interventions are very discretionary and significant in size.
iv. Contrary to what could be thought, exchange rate flexibility makes a positive contribution to financial stability.

Commercial and financial integration with the rest of the world is well consolidated.

- Chile has signed free trade or equivalent agreements with its main trade partners.

- The common trade tariff applied for imports stands at 6%, but the effective average tariff, given those trade agreements, lies below 1%.

- Foreign exchange restrictions for financial flows has been eliminated and what remains in place are information requirements and anti-money laundering and other anti-crime preventions.

In addition, financial policies have led to quite developed and deep financial markets

- Different indicators show a satisfactory provision of finance for households and corporate firms in different time horizons.
- The pension fund system, introduced four decades ago, has been decisive in developing a relatively developed capital market, which was previously almost inexistent.
- Pension funds and insurance companies are major players in this market. They provide medium and long term funds for both the corporate and the banking sectors and, as a consequence, contribute to market discipline and stability.

The regulatory framework for banks is assessed as robust and it has work well in practice for the last 3 decades.

- It experienced a complete overhaul in the mid eighties, after the crisis.
- Since then, a seal of prudence has remained in place until present days, although this receives some criticisms from time to time.
- Apart from that, an element that distinguishes Chile´s framework is the equilibrium between regulation and supervision, under the assumption that they are both equally necessary for attaining financial stability.

Supervision has proven to be effective.

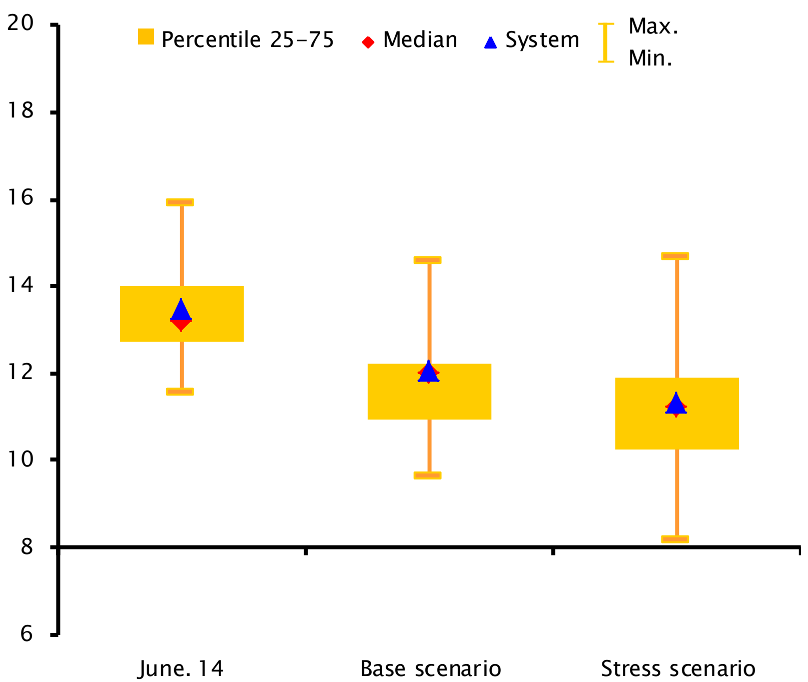
- Its focus lies not only on compliance, but mainly on risk management.
- Although supervision is done by a public agency (the superintendence of banks), separate from the Central Bank, there has been a permanent effort to keep coordination and communication between both institutions at a high level.
- The supervisory agency has been assessed as highly professional, however it should be given further independence to fully comply with international recommendations, like the ones set by the Basel Committee.

In addition, the Central Bank, as part of its financial stability role, conducts regularly stress tests for the banking system.

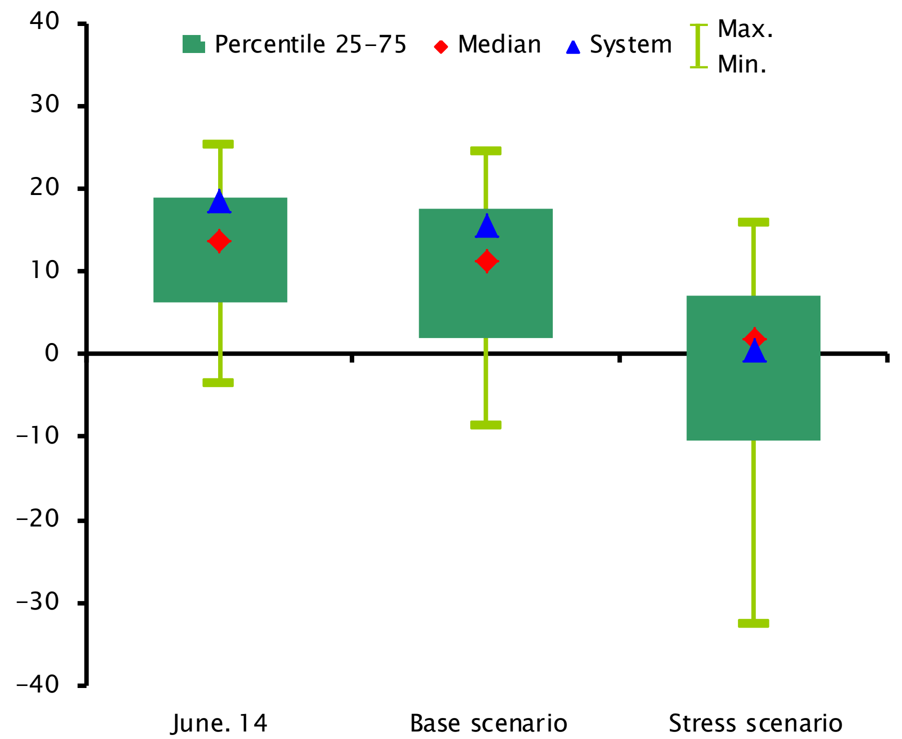
- The focus of these exercises is on the system as a whole more than on individual institutions.
- In any case, this is conducted in close cooperation with the Supervisory Agency.
- Results are reported twice a year in Financial Stability Reports.
- Starting this year, results for each individual bank are shared with their respective top executives. This initiative has received good reception from the industry.

Stress tests confirm the safety and soundness of Chile's banking system.

Capital adequacy under current situation and stress scenario
(%)



ROE under current situation and stress scenario
(%)



1. Only commercial banks
2. Systen weighted common equity
3. Min and Max are 10 and 90 percentile, respectively

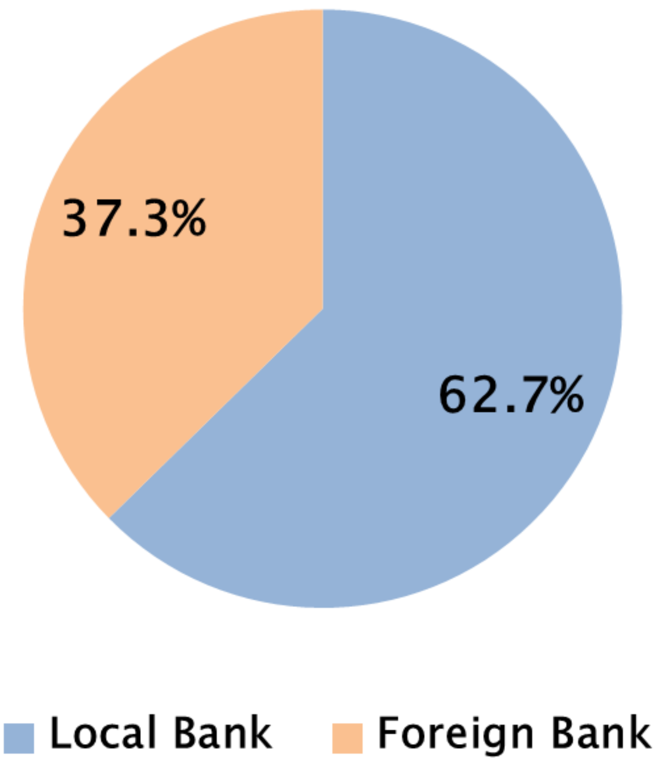
Source: Central Bank of Chile, Financial Stability Report (2014.2)

For quite a long time, financial regulation has been friendly with foreign banks and foreign investors in general.

- Access to the market is open and subject to standards requirements (solvency and fit and proper requirements).
- This means that foreign banks may establish offices in the country or buy existing banks.
- At the operational level, there is no discrimination between foreign and national banks. They are both subject to the same rules and treated on the same grounds.

As a result of this open-door policy, market share of foreign banks has become relevant.

Loan Market Share by Type of Bank (*)



(*) Local Banks include: Banco de Chile, Banco del Estado, Corpbanca, BCI, BICE, Security, Falabella, Paris, Penta, Ripley, del Desarrollo. Foreign banks include: Santander, Scotiabank, HSBC, Itaú, JP Morgan, Deutsche, BBVA, Rabobank, Do Brasil.

Source: Superintendence of Banks and Financial Institutions.

However, several foreign banks prefer the option of holding a representative office.

- This is an interesting option given the country´s financial openness.
- The number of representative offices total 27, out of which 15 correspond to European entities.
- However, it is important to say that these offices are not permitted to act as bank in the local market. They are only allowed to represent the interest of their respective mother bank.

Although the regulatory framework is assessed as robust, it is possible to identify opportunities for improvements in certain areas. It can be mentioned, among others, the following ones:

- Liquidity regulation for banks.
- Capital regulation for banks.
- Financial conglomerates.
- Financial infrastructure for OTC derivatives.
- Resolution for problem banks.

Liquidity regulation for banks.

- Liquidity regulation is set by the Central Bank.
- The traditional approach has been to set limits to mismatches for different temporal bands.
- The Central Bank and the Supervisor Agency, after a market consultation process, have recently released new rules for liquidity adequacy.
- They will be effective next August and will replace rules that were in place for the last 10 years.

Liquidity regulation for banks.

- New rules innovate in several aspects.
- Firstly, the board of directors and the high administration are assigned greater responsibilities in setting directives and specific targets for liquidity positions.
- And secondly, the ratios recommended by the Basel Committee –the LCR and the NSFR– are formally introduced to be used for supervisory purposes.
- However, at this stage, no regulatory values or targets have been established for those ratios.
- It was considered necessary to have a period to assess the impact of this new regulation before specific targets are set.

Capital regulation for banks.

- Chile is under the Basel I framework for capital regulation. It never moved to Basel II and, as the financial crisis came out in 2008/9, decisions were postponed.
- However, it has to be said that Basel I was well implemented and, as a consequence, weaknesses and loopholes observed in other jurisdictions were not observed in Chile.
- In any case, the need to move to Basel III is under no discussion.
- This view is shared by Government authorities as they have announced that a bill introducing Basel III capital rules will be sent to Congress for approval in the near future.

Capital regulation for banks.

- Quantitative exercises tend to show that moving to Basel III will mean a change, but not a drastic one given the current level and composition of the banking industry´s capital.
- In this area, regulation has been prudent since Basel I was introduced:
  - Regulatory capital is composed mainly of common equity and retained earnings.
  - Subordinated debt is constraint in size and on the nature of permitted instruments.
  - The ratio of common equity to risk weighted assets can not be lower than 4.5%.
  - In addition, a leverage ratio no higher than 3% is required.

Capital regulation for banks.

- However, gaps need to be filled in relevant aspects.
- Convergence in the treatment of market risk is limited.
- There are no capital charges for operational risk.
- Internal models are not allowed for capital management.
- Capital buffers recommended by the Basel Committee are not considered.

Regulation and supervision for financial conglomerates.

- This issue has been raised by the IMF and the WB in financial assessment exercises.
- However, it is important to realize that Chile’s corporate sector presents certain features that are not common in advanced economies.
- This includes the presence of entrepreneurial groups involved in different sectors of the economy including the financial industry.
- In this context, several questions are raised, among other, where boundaries should be drawn for the purpose of financial regulation and supervision.

Chile's regulatory and supervisory framework has provided a robust line of defense for dealing with banks belonging to an entrepreneurial group. This includes:

- Full consolidation at the level of the bank holding company.
- Strict solvency requirement for owners that exercise the effective control of a given bank. In a recent legal amendment, this requirement became permanent.
- Strict limits on related-party lending for the entire conglomerate and effective enforcement of those rules.
- Increasing coordination and communication among financial authorities as shown by the introduction of the Superintendents Committee and the Financial Stability Council.
- Although this approach has proven to be effective, there is still room for improvements so as to further reduce potential risks coming from sources outside the bank.

Financial infrastructure for OTC derivatives.

- Financial derivatives are widely used in advanced economies and they are gaining increasing importance in several emerging economies.
- However, the lack of an adequate regulatory framework imposes risks with potentially adverse consequences on financial markets.
- Learning the lesson of experience, several recommendations to reduce risks have been formulated in the aftermath of the global financial crisis.
- They include moving trading to organized markets, at least for certain types of instruments, and using central clearing for those that remain in OTC markets.

Financial infrastructure for OTC derivatives.

- In Chile, the derivative market is almost exclusively OTC.
- Volumes have increased over time induced in part by the exchange rate floatation, but the level of sophistication is still low.
- Turnover rose from 1.6% of GDP in 1998 to 5.3% in 2013, but activity is still concentrated in interest rate swaps and non-deliverable forwards.
- Main market participants are banks (with a market share of around 61%), followed by pension funds (with a market share of 19%).

Financial infrastructure for OTC derivatives.

- Clearing is done on a bilateral basis, but initiatives to start using a central counterparty framework are underway.
- A central counterparty for exchange traded derivatives was approved a year ago and a similar entity for OTC received recently the authorization to become operative.
- Banks, major players in the derivate market, have mentioned their interest in making use of central counterparty facilities.

Banking resolution.

- Current regulation on banking resolution relies mainly on market base mechanisms and liquidation when those mechanisms fail.
- The effectiveness of this framework has not been sufficiently tested as it has been applied just in few cases involving small banks but not in systemic crisis.
- As a consequence, it seems quite clear that it needs to be enhanced.

Banking resolution.

- Along that line, it has been suggested the possibility of giving additional powers to supervisors to intervene and take actions, so as to facilitate resolution, particularly in case of a systemic crisis.
- There is a wide agreement to include this issue in the reform agenda, although the details need to be worked out.

Final remarks.

- Chile’s banking system has shown a high level of stability over time.
- The macroeconomic policy framework has made a valuable contribution for making it possible.
- Regulation and supervision have also made a decisive contribution.
- However, opportunities for improvement have been identified to set a reform agenda.
- Some actions are underway and others are in the pipeline.
- The implementation of this agenda will provide further strength to Chile’s financial system.