Chile and the International Regulatory Agenda

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Following the Global Financial Crisis, the international community developed a new set of standards and principles for banking regulation

- These standards seek to increase the amount and quality of banks' capital to allow them to remain solvent even after facing large unexpected shocks.
- They also aim to reduce the complexity of banking businesses, the incentives to become too-big-to-fail, and tame counterparty risk.
- Also, to improve the banks' resilience to funding shocks,
- These new principles and standards are good and also unavoidable for a country financially integrated with the rest of the world.

Elements of the international standards have long been present in our regulation, but full adaptation will require changes

- Liquidity requirements linked to projected cash inflows and outflows have been in place since 1999.
- Leverage ratio restriction of 3% (common equity capital to total assets) is a legal requirement since 1997.
- Legal restrictions to “large exposures” and “related lending” have been in place for more than 20 years.
- Beyond BCBS policy recommendations, our legal and regulatory framework follows a conservative orientation. In fact, most of complex activities are explicitly prohibited:
  - Banks cannot invest directly in equities, commodities or CDS.
  - Banks can trade derivatives using only two types of underlying assets, namely, interest rates and currencies.

In our institutional framework, the Central Bank regulates banks' liquidity and market risk

- Banks in Chile have been subject to liquidity requirements linked to cash inflows and outflows well before the LCR and NSFR.
- 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.
- However, recognizing the relevance of the new Basel standards, the Central Bank of Chile updated its liquidity regulation in 2015. The new framework is currently in force.
- This new regulation broadens and strengthens our current regulatory requirements and imposes the obligation to regularly compute and disclose the LCR and NSFR ratios to the Supervisor.

We are also advancing towards full adaptation of the Basel III liquidity framework

- Today, banks regularly report to the Supervisor all the required information.
  - While not yet imposing a minimum regulatory limit on these new ratios, the Supervisor and the CBC have now more and better information on liquidity risk to guide their analysis.
- Calibration for future quantitative requirements on these ratios is currently underway, expecting to put new regulation in consultation in the second half of 2017.

In our current framework, solvency requirements are established by law. Adapting to new standards requires legal changes

- The General Banking Act in force specifically defines capital requirements, risk weights and capital instruments according to Basel I.

- Hence, most of the reforms needed to adopt the Basel III solvency standards require a legal change, for example:

  1. Additional Tier 1 instruments.
  2. Capital conservation buffer.
  3. Macroprudential tools, such as the Countercyclical Capital Buffer and "systemic" capital surcharge.
  4. Inclusion of market and operational risks to measure capital ratios

There is broad agreement among regulators and the industry on the importance of adapting to the new solvency regime established in Basel III

- There have been various attempts to modify our banking regulatory framework in line with new international standards.
- The current Administration has made important advances on this front:
  - Putting together a consultative group to make recommendations for a new banking act, and advancing in pre-legislative discussion for a draft law
- Some aspects of the intended reform are complex and may require additional discussion (e.g. banks' resolution framework)
- But there is broad consensus on the need to advance in all aspects of the new Basel III solvency framework.

Furthermore, the additional capital required for full implementation of Basel III solvency standards in Chile appears manageable

- Depending on the assumptions used, full implementation of Basel III would imply a deficit of Tier 1 of about 10% of the current total capital of the system.
- Considering a period of phase-in for the requirements, we estimate banks will have the capacity to raise capital without causing disruption in the credit market.
- The calibration of regulations should also help to ensure a smooth transition.

Challenges ahead: regulatory implementation of the Basel III solvency framework

- The approval of a new legal framework for solvency requirements is the most urgent task ahead, but significant work will be needed for its implementation:
  - New regulations on market risk, operational risk, credit counterparty risk.
  - Development of the “internal models” regulatory scheme,
  - New regulations or protocols for the systemic capital surcharge and the countercyclical capital buffer, etc.
- Additionally, there are concerns about the actual possibility for some banks to issue “non-traditional” capital instruments, given the depth of the local market and potential restrictions on institutional investors, such as pension funds and life insurance companies.

Challenges ahead: regulatory implementation of the Basel III solvency framework *(cont'd)*

- Regarding the implementation of the LCR and NSFR ratios, detailed calibration of the "weights" is necessary and also a determination of the scope of its application.
- We are currently analyzing the reported data, and their coherence with Basel III liquidity standards.
- In this context, the projected availability of high quality liquid assets is a concern, as has been the case in other economies.
- We will carefully consider all these aspects in future changes of our regulation.

Concluding remarks

- Chile has closely followed the international debate on the new standards for banking regulation and supervision.
- Nevertheless, the adoption of these standards has not had the same sense of urgency as in those countries that suffered the most from the global financial crisis.
- Some elements of the new standards were already part of our regulatory framework.
- Faster convergence has taken place where no legal changes were necessary. Best example is the adoption of the liquidity standards.
- Where changes in law are required, convergence has been slower, not because of lack of consensus on adopting solvency standards, but because of the breadth of the proposed changes to the Banking Act.
- The challenges ahead are mainly related to the development of regulation once a new Banking Act is eventually approved.

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