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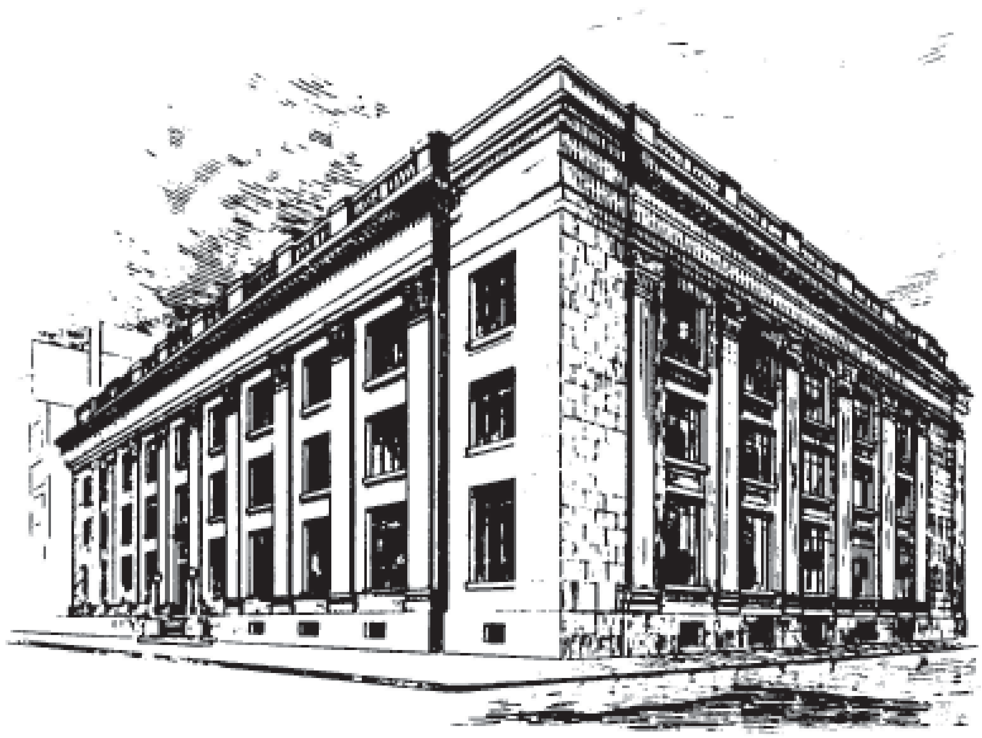

Transition to Basel II:
Policy Lessons of the Chilean Experience

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N.° 21 - November 2007

ECONOMIC POLICY PAPERS

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Documentos de Política Económica del Banco Central de Chile
Economic Policy Papers of the Central Bank of Chile
ISSN 0717 - 7151

Agustinas 1180 - Santiago, Chile
Teléfono: (56-2) 6702475; Fax: (56-2) 6702231

TRANSITION TO BASEL II:
POLICY LESSONS OF THE CHILEAN EXPERIENCE

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October, 2007

Abstract

This document presents an overview of the Chilean banking system and the steps taken so far in its transition to Basel II. The balance of the process so far is positive reflecting reforms over the last two decades that paved the road for a smooth transition to the new capital framework. However, the complexity of Basel II calls for special attention to the way in which it is implemented. The analysis of Chile's experience to date is, therefore, an interesting exercise, offering policy lessons that may be a valuable input for other countries considering adoption or currently moving towards Basel II.

Chile has yet to complete its transition to Basel II but, almost four years after announcing its decision to adopt the new capital framework in January 2004, a significant number of measures have been taken by both the country's supervisors and its banks and they have acquired valuable experience in the process. As a result, it is interesting to assess progress so far and to examine preliminary policy lessons, some of which may be helpful to other developing countries as they seek to address their own implementation challenges.

I. The Chilean banking system[1]

The Chilean banking system is small by any standard. The number of institutions does not surpass thirty, and those considered full banks account for no more than half of that figure while the remainder are small specialized institutions or branches of international banks. Moreover, although the system's total assets as a ratio to GDP, at more than 90%, are relatively large compared to other developing countries, they reach only 150 billion dollars.

The severe crisis suffered by Chile's banking industry in the early 1980's, which put most institutions into technical bankruptcy, is now past history. Today, the system is on a completely different footing and appears fundamentally sound. Its capital ratios have remained well above the legal minimum as well as above market standards, although they have recently seen a slight drop as activity has expanded strongly. At present, the industry has an average Basel Index around 12.5% and no institution is below 10%. Over the last decade, its past-due ratio has remained within the 1-2% range and has now dropped to just below 1% in a cyclical movement that reflects a favorable economic environment. Provisions have followed a similar pattern but, for prudential reasons, have remained above 1%.

Profitability has also remained high and stable over time, with return on equity running at between 9% and 22% and averaging around 16% over the last 15 years. This performance, which is an additional source of strength for the industry, compares favorably with that of other countries.[2] In addition, the general view is that the industry enjoys high professional management standards.

Regulation and supervision have gradually been strengthened. The current framework is based to a large extent on modern concepts of prudential regulation and risk-based supervision. An external assessment of the Basel Core Principles for Effective Banking Supervision (BCP), conducted under a Financial Sector Assessment Program (FSAP) in 2004, found a level of compliance similar to that observed in developed countries, suggesting that the system is prepared to adopt new international standards and recommendations, including the new capital framework.

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[1] A summary of data on the Chilean banking system is presented in the Annex.

[2] For figures on return on equity in the banking industry for a list of different countries, see the "Statistical Appendix" of the IMF's "Global Financial Stability Report".

Market discipline has also increased. In this area, the creation of a private pension fund system in the early 1980's played a decisive role, not only by contributing to the development of the domestic capital market, which was previously of insignificant size, but also because it meant improvements in financial disclosure and transparency. It also favored the development of a private ratings industry which has acquired important experience during the past 20 years and has developed formal links with global rating agencies.

Foreign banks have a significant presence in both corporate and retail activities, with a total market share of around 40%, and have made a significant contribution to banking development, particularly in promoting financial innovation and corporate governance standards. Domestic privately-owned banks represent 50% of the market and the only state-owned bank, BancoEstado, accounts for the remaining 10%.

Bank exposure is mostly domestic. Despite their ready access to international markets, neither domestic nor foreign banks in Chile have shown significant cross-border expansion. In addition, lending is conducted mainly in local currency, with foreign-currency funds used to finance exporters or other clients with foreign-currency revenues. The ratio of foreign-currency loans to total loans has remained at around 15% with no major changes over time and foreign-currency funding is available from different sources so banks are well able to match their exposures.

The presence of mixed-activity financial conglomerates in the banking industry has historically been significant. Currently, ten of the 26 banks operating in Chile, representing close to 50% of the loan market, are part of such conglomerates. This figure will be substantially reduced if two recently-announced mergers are completed in the coming months.[3] Although they are not subject to fully-consolidated supervision - something that would be extremely difficult to implement given their complexity - these conglomerates are subject to strict regulation to avoid undesirable practices, such as self-lending and, as a general principle, have to run their banking business separate from the rest of their activities to prevent any contagion.

In the past, lack of competition was perceived as a problem but, although competition remains limited in some segments of the retail market, the situation has improved as new players have entered the market. Spreads have become quite competitive in corporate banking but continue to be relatively high in retail banking where efficiency still needs to improve. For this reason, the use of new technologies, like ATMs[4], debit cards, electronic banking and sophisticated credit-risk analysis based on good credit reporting, need to be fostered further in order to bring down production and transaction costs and risk premiums and, as a consequence, credit spreads.

[3] The two mergers referred to are that between Banco de Chile and Citibank Chile and that between Scotiabank and Banco del Desarrollo.
[4] ATM is an acronym for automated teller machine.

Banking penetration is relatively high compared to other developing countries and access to bank services and finance is quite widespread. However, it still needs to expand in the segment of small and medium-sized enterprises and among individuals, groups of which a significant proportion continue to be under-bankarized or not bankarized at all.

All these positive factors are widely recognized by market analysts and credit rating agencies. Chilean banks, for instance, hold investment-grade ratings in local and foreign currency and some leading institutions have the same rating as the country - that is, single A. A similar positive view is reflected in a report issued by the International Monetary Fund (IMF) on banking strength across countries where the Chilean system ranked in first place among emerging economies.

Nonetheless, Chile still faces a number of challenges. As well as the expansion of banking and financial services to new segments of the population, these include progress towards consolidated supervision, the fostering of greater competition, the establishment of accounting rules in line with international standards, and a successful transition to Basel II.

II. Preparing the transition

In Chile, preparation for the transition to Basel II has coincided with a process of integral improvement of regulation, supervision and risk management that dates back to the banking crisis of the 1980's. In the wake of this experience, the foundations of prudential regulation and supervision were gradually laid.

This process included a number of far-reaching reforms implemented in recent years. These were necessary and beneficial in their own right but had the added advantage of paving the road for Chile's adoption of the new capital framework. In addition, measures more specifically geared to the transition to Basel II have also been implemented of which the most significant include:

1) **Risk-based supervisory model**

In 2001, Chile's bank supervisor, the *Superintendencia de Bancos e Instituciones Financieras* (SBIF), adopted a full risk-based supervisory model, definitively abandoning its traditional rules-based model.[5] In line with this new focus on risk management, the three main banking risks (credit, market and operational risks) were separately identified as relevant for a bank's performance.

Under the new model, banks are evaluated periodically and receive a supervisory rating which is not disclosed to the public. When weaknesses are detected, corrective

[5] For further details, see Article V of the General Banking Act and Chapters 1-13 of "Recopilación Actualizada de Normas" by the SBIF (both documents available on the SBIF's website, www.sbif.cl).

measures are recommended, the direct involvement of the board of directors is required, and progress is closely monitored by the supervisor.

In 2005, this model was updated and revised principally with the aim of providing a more precise identification and definition of the elements that would be subject to supervisory assessment. Subsequently, the management of capital was included as one of the key factors to be evaluated.

2) **Update of loan classification and provisioning system**

In 2004, Chile's loan classification and provisioning system was updated and improved in order to serve as an effective tool for managing expected risks and losses.[6] The main drawback of the previous system was its excessive reliance on supervisory assessment of individual credit exposures and risks.

The new system, which is consistent with Basel II definitions, obliges banking institutions to take much more responsibility while, at the same time, allowing them greater flexibility in the use of internal models based on credit-risk concepts.

Under this new system, a bank's board of directors is required to make a formal pronouncement, at least once a year, on the adequacy of its provisions, thereby shifting the focus of supervision to credit-risk management and away from individual credit ratings. Banks are now using the new guidelines to report the credit-risk profile of their loan portfolio and this has meant a major improvement in terms of disclosure and transparency.[7]

3) Convergence of local accounting rules with international standards

The banking system has led the way in the Chilean corporate and financial sector as regards to the process of convergence of local accounting rules to International Financial Reporting Standards (IFRS), which was launched in 2004. This medium-term project is considered essential for enhancing financial disclosure, transparency and, as a consequence, market discipline. An important step was taken in 2005 when fair-value accounting was introduced for financial investments and derivatives.[8] According to the time-table announced by the SBIF, full implementation of the new standards is expected for 2009.

4) Assessment of the external ratings industry

In principle, Chile's external ratings industry appears prepared to support implementation of the standardized approach to credit risk. It is a relatively mature

[6] For further details, see Chapters 7-10 of "Recopilación Actualizada de Normas" by the SBIF (available on the SBIF's website, www.sbif.cl).
[7] As part of the process of adoption of International Financial Reporting Standards in the banking sector some adjustments to the loan classification and provisioning system are expected in the coming months.
[8] For further details, see Chapters 7-12 of "Recopilación Actualizada de Normas" and Circular Nº 3.300 by the SBIF, January 5, 2005 (both documents available on the SBIF's website, www.sbif.cl).

industry that has accumulated important experience over the past 20 years and provides reasonable coverage of the corporate sector.

The main drawback in this area is that the scale used to assign local ratings is not fully consistent with that used for global ratings, and this poses questions that need to be addressed if the standardized approach is to be implemented.[9]

5) Quantitative impact studies and stress-testing exercises

Quantitative studies of the impact of the new accord have been carried out for the banking system as a whole, based on the guidelines of the standardized approach.[10] These show that Basel II would not have a major impact on capital requirements and, using strict Basel II criteria, the exercise, in fact, indicates a slight reduction in capital requirements for the system as a whole, although the impact is not uniform across banks.

Stress-testing exercises have also been conducted to simulate the potential effects of significant macroeconomic shocks - including major devaluations or revaluations, drastic changes in interest rates and a serious deterioration of credit quality - on the profitability and solvency of the banking system as a whole.[11] The results indicate that these macro shocks would have an impact on profitability as measured by return on equity, but only a limited impact on solvency as measured by the Basel I Capital Index. According to a study by the Central Bank of Chile, using three different stress scenarios, the system's average Basel I Index would fall only marginally and no bank would drop below the 8% regulatory requirement.[12]

6) Assessment of Basel Core Principles for Effective Banking Supervision (BCP)

In 2004, an external evaluation of these principles was carried out by a joint IMF-World Bank mission under an FSAP program. It revealed an 83% level of compliance, which is comparable with the average level found in developed countries. The evaluation identified weaknesses in areas such as capital allocation for market risk, prevention of money laundering, legal protection for banking supervisors and consolidated

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[9] For further details, see Günther Held, Adriana Emhart, Magali Giudice and Luis Raúl Romero, "Calificaciones de riesgo, ponderadores de riesgo y requisitos de capital", 2006, (available on the SBIF's website, www.sbif.cl).

[10] For a summary of the results of the last available quantitative impact study (QIS 5), see "Developments and Remaining Challenges Related to Basel II Implementation", presentation by Gustavo Arriagada, Superintendent of Banks at the ASBA/FSI Meeting, Miami, April 25-26, 2006 (available on the SBIF's website, www.sbif.cl).

[11] See Carlos Budnevich Le-Fort and Sergio Huerta Vial, "Ejercicios de Tensión del Capital en la Banca Chilena", May 2006 (available on the SBIF's website, www.sbif.cl).

[12] See "Informe de Estabilidad Financiera, Primer Semestre 2007" Central Bank of Chile (available on the Central Bank's website, www.bcentral.cl).

supervision.[13] Since the results of the assessment were released, significant progress has been made in most of these areas.[14]

7) Allocation of capital for market risk

In 2005, the Central Bank of Chile established new regulation that is very much in line with the Market Risk Amendment (1997)[15] under which banks were required to manage their risks using the so-called standardized approach and were subsequently offered the possibility of moving to the internal model approach, subject to prior approval from the supervisor.[16] Although the legal definition of the minimum capital requirement did not change, in practice this meant the incorporation of capital charges for market risks.

8) Plan for the transition to Basel II

In early 2005, the SBIF and the Central Bank presented a plan for the transition to Basel II, which is currently being implemented according to schedule.[17] This plan establishes a number of guiding principles for the transition process:

a) It will be conducted jointly by the SBIF, which is responsible for supervision, and the Central Bank, which monitors financial stability;

b) The transition will be gradual and stepwise. In the first stage, only the standardized approach to credit and operational risk will be adopted and the option of adopting advanced models will be offered only in the second stage;

c) Close communication and coordination with the industry will be maintained throughout the transition process;

d) Full collaboration will be extended to relevant foreign supervisors and support will be provided for international groups with subsidiaries or branches in Chile

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[13] See "Compliance with the Basel Core Principles for Effective Banking Supervision", which summarizes the assessment conducted by the IMF/World Bank (available on the SBIF's website, www.sbif.cl).

[14] Law N° 20,190, published on 06/05/07 (also known as the "Second Capital Market Reform"), addressed the issue of legal protection for banking supervisors. In addition, it gave the SBIF powers to require information from bank subsidiaries involved in non-banking businesses in order to strengthen consolidated supervision at the level of the bank holding. Several material improvements have also been made in the field of the prevention of money laundering, including additional powers for the Financial Analysis Unit (UAF), which started operations in 2004 and is now fully operative. Finally, bullet number 7 of this section covers the issue of market risk and its incorporation for capital allocation requirements.

[15] The original title of the document published by the BIS is "Amendment to the capital accord to incorporate market risks" but it is commonly referred to as the "Market Risk Amendment". It was originally released in January 1996, modified in September 1997, and further revised on November 14, 2005.

[16] For further details, see Chapter III.B.2, "Compendio de Normas Financieras" (available on the Central Bank's website, www.bcentral.cl).

[17] See "Road Map Guidelines: Transition to Basel II" consultative document, January 2005, and "Hoja de Ruta Hacia Basilea II, 2007-08" November, 2006 (both documents available on the SBIF's website, www.sbif.cl).

so they can implement Basel II at the level of their parent company according to the criteria set by the home country supervisor. However, all banks operating in Chile's jurisdiction, whether local or foreign, will be subject to the decisions and recommendations contained in the transition plan.

III. Policy Lessons

Although it is still somewhat premature for a complete assessment of Chile's transition process to Basel II, some preliminary policy lessons can already be identified.

Basel II acceptance

Although there are, of course, still issues that cause concern and need to be clarified or resolved, the view that the new capital framework represents a major step forward for regulation, supervision and risk management has gained ground in most developing countries and is now widely accepted.

There is no doubt that Basel II is absolutely necessary for internationally active banks since it allows for more risk-sensitive capital allocations and provides a level playing field for those competing globally or, at least, in different markets. Moreover, given the ever-increasing complexity and sophistication of financial products and services, there is little doubt that the new capital framework is important for large institutions, regardless of whether they target domestic or global markets.

Concerns arise, however, when considering implementation among small and medium-sized banks, particularly in developing countries. In spite of this, Basel II will have a positive impact even in jurisdictions where adoption is not a straightforward decision because it provides a new framework for dealing with regulation, supervision, risk management, corporate governance and market discipline and, regardless of the technicalities of calculating capital requirements, is designed to promote advances in all these areas, thereby strengthening financial stability.

Prior assessment of regulation and supervision

Basel II requires strong regulatory and supervisory foundations. As a result, prior to implementation, it is necessary to establish an accurate diagnosis of the current state of regulation, supervision and bank management.

Most of these issues are referred to in the BCP. A formal assessment of BCP compliance, therefore, is useful in identifying areas that will require improvement or reinforcement during the transition. A review under an FSAP is a sensible option since it has the advantage of using a proven and standard methodology. In Chile, the assessment made by an IMF/World Bank mission in 2004 was very useful and, as mentioned above, led to initiatives to address most of the weaknesses that were identified.

Basel I compliance first

Basel II has been proposed as a more risk-sensitive and efficient capital framework. It is not intended to increase capital requirements but to improve standards of risk management and supervision within the banking sector. However, moving to Basel II will be difficult and will not receive the necessary industry support if it is associated with a significant increase in capital requirements.

As Basel II is a far more complex framework, serious shortcomings in the implementation of the previous framework need to be resolved first. Recurrent issues in developing countries include under-estimation of risks, over-valuation of risk mitigation factors and under-provisioning and over-valuation of capital. As a result, capital adequacy is usually far from appropriate, even in cases where formal requirements are met.

In Chile, a serious weakness in Basel I implementation was the lack of capital charges for market risks. This was resolved in 2005 when the Central Bank replaced existing rules for market risks based on limits for asset and liability mismatches with new regulation based on risk assessment and capital allocation.

Reinforcing provisioning standards

The proper management of provisions is essential for implementing the new capital framework. This is particularly so in developing countries where cyclical economic fluctuations have historically tended to be larger. In periods of severe economic and financial stress, a bank's capital may turn out to be insufficient and difficult to restore. In these circumstances, provisions will provide an additional source of strength, particularly when they are calculated to cover expected losses over the cycle. Moreover, it can be argued that a well-designed provisioning system may partially offset the pro-cyclical effects of capital requirements. Provisions are related to expected risks and losses and can, therefore, be assessed using the same analytical framework proposed by the new capital framework. This means that the enhancement of provisioning rules and practices will also pave the road for the transition to Basel II.

Small banks

Small retail-oriented institutions, micro-finance entities and cooperative banks have a significant presence in most developing countries. Their main comparative advantage vis-à-vis large institutions is their knowledge of clients with whom they tend to have close relations and this usually offsets their disadvantage as regards raising capital. In general, they have come under Basel I but the question now is whether they should move to Basel II.

For these banks, the complexity and cost of implementation may well outweigh the potential benefits. As a result, there is widespread agreement that an excessive burden should not be placed on these institutions. If the policy decision is that they should also move to Basel II, a simplified version of the standardized approach would probably be the best option.

Competitive implications

Implications for the domestic and international competitiveness of banks need to be permanently assessed. In order to maintain a level playing field, comparable banks should receive comparable treatment, which is easy to say but more difficult to put into practice. Excessive emphasis on equal or similar treatment of all banks within a country could put some at a disadvantage internationally while, on the other hand, there is a risk that too great a differentiation could create competitive inequalities in the domestic market.

The increasing integration of financial markets also means that the new capital framework may have competitive implications beyond the banking industry. The distinction between different types of financial entities is no longer as clear as in the past since a range of non-banking financial institutions now undertake activities such as consumer lending, mortgage generation and credit card issuance that were previously carried out exclusively by banks. The implementation of Basel II will again raise the issue of regulating activities instead of institutions, which has important competitive implications in financial markets.

Corporate governance standards

New regulatory trends require high corporate governance standards. To promote efficiency and innovation, policymakers and regulators are giving banks more flexibility to set policies and manage risks. The practical implication of this new approach is that their corporate structure needs to be improved in areas that include the functioning of the board of directors, the role of top managers and internal controls. These concepts are well embedded in Basel II, which allows banks to use their own internal models, but simultaneously demands a strong internal process for assessing capital adequacy. For this reason, the improvement of corporate governance standards and the promotion of good practices and self-regulation are essential for implementing the new capital framework and, particularly, Pillars II and III. This has been a priority in Chile where supervision currently attaches great importance to the functioning of the board of directors, including that of the audit committee, mainly in connection with risk management.

The role of market discipline

Market discipline plays a key role in supporting regulation and supervision. As a result, it is increasingly seen as a necessary condition for maintaining the safety and soundness of the financial system. Given the current trend towards increased flexibility in risk management, the importance of market discipline is even greater and this is particularly so for the implementation of the more advanced approaches of Basel II. Greater flexibility in managing capital adequacy means an increased need for some form of market as well as supervisory validation. For market discipline to work, financial disclosure and transparency standards need to be enhanced and, in this context, an early priority should be to bring accounting rules as closely as possible into line with international standards.

Gradualism

In most developing countries, Basel I was not implemented immediately and in Chile, for example, did not come into force until almost ten years after the original document was released. Similarly, the implementation of Basel II will necessarily require a long time as well as hard work. The preparation and discussion of the final Basel II document took several years and there is no reason to expect that implementation will take significantly less time.

Taking this into account, realism and pragmatism must prevail when setting transition plans and timetables. For most emerging economies, the correct strategy will be to move gradually and step-by-step. This means implementing first the standardized approach and considering the possibility of moving to the advanced approaches only once knowledge and experience have been acquired. The standardized approach may be perceived as excessively simple for the complexities of banking activities in developed countries but offers advantages for developing countries where banking activities are, in most cases, still rather simple and credit exposures are mainly domestic. In these circumstances, it may prove to be the best option after costs and benefits are adequately weighed.

External ratings

The use of external ratings, considered under the standardized approach, raises some concerns, most importantly because they are neither widely available in developing countries nor is their quality well-established. As a result, their use under the standardized approach may not be recommendable.

In addition, even where their coverage and quality seems reasonable, the scale used locally may not be fully consistent with international scales, meaning that while they may be useful for domestic comparisons, this is not the case for cross-country analysis. Differences in scales are related to local versus foreign-currency denominations as well as to the ceiling for cross-border transactions imposed by the sovereign rating. This problem is more serious and more difficult to resolve in countries below investment grade where deviations between local and international ratings are significant. In any case, under the standardized approach, supervisors will need to provide guidelines for the use of local external ratings and, in this task, the involvement of the ratings industry will be required.

It is important to note that these problems with external ratings in no way prevent the implementation of the standardized approach since it considers the option of using a common risk weight of 100% for all corporate exposures. When external ratings do not provide adequate coverage of corporate risks or are not reliable enough, the best policy decision is not necessarily to jump immediately to the advanced approaches, but to build or strengthen the banking industry's capacity to assess credit risks. The lack of a reliable ratings industry could indicate a gap in risk assessment that needs to be filled before relying on internal ratings.

Practical use of capital indexes

A key concept under Basel I has been the so-called Basel Index, which is the ratio of capital to risk-weighted assets. This simple and easy-to-measure index is extensively used at the board and management level and for external assessment by market analysts and ratings agencies as well as by regulators and supervisors. In banking and securities markets, we find an increasing number of rules that refer to the Basel Index and, in Latin America, several countries have set minimum capital ratios well above 8% for macro-prudential reasons.

These indexes lose importance under the new capital framework as they become much more difficult to calculate and interpret. Moreover, their use by regulators and supervisors may turn to be meaningless and, therefore, ineffective. The challenge for policymakers and supervisors is to find a new simple measure, possibly a revised version of the Basel Index, by which to set rules and benchmarks.

Home/host communications and cooperation

One of the key challenges of Basel II is to establish effective mechanisms for cooperation and communication between the supervisors of different countries, a field in which most have little experience. Although the sharing of information related to money laundering and licensing has helped in recent years, there is only limited experience of sharing responsibility for the supervision of a common standard, such as the new capital framework.

One of the most sensitive areas for collaboration between home and host supervisors are the subsidiaries or branches of foreign banks since, at least during the transition period, these and the parent company could well find themselves operating under different capital regimes. As foreign banks have an increasing presence in most developing countries, it would seem advisable to focus on those institutions with a significant or systemic importance, otherwise the burden and cost of establishing communication and a cooperation framework with all foreign supervisors may prove too onerous.

Involvement of banks and bankers

Although supervisors continue to have a vital role, the implementation of Basel II is mainly the responsibility of banks and bankers, and they must play an active role in the transition. As long as supervisors are the only party committed to this project, progress will be limited and they should, therefore, motivate banks to assume their respective tasks. Seminars and conferences can be useful tools but, perhaps, the most effective course of action is to establish a working group in which both the industry and supervisors can analyze issues of mutual interest and, in general, monitor the transition's progress. In Chile, such a group, bringing together supervisors and bank practitioners, was set up and is currently functioning, and has proved a very useful vehicle for industry involvement.

Coordination with the Central Bank

In some jurisdictions, bank supervision is the responsibility of an agency different from the Central Bank, raising the issue of communication and coordination between the two institutions. In such cases, although the Central Bank is not involved in supervising individual institutions, it usually has some responsibility for monitoring financial stability from a macro or systemic standpoint and, in any case, the relationship between Basel II and the safety and soundness of the banking system as a whole is evident.

Additionally, although the Central Bank is not involved in supervision, it usually has regulatory powers in areas that are directly or indirectly related to Basel II and those powers will have to be exercised during the implementation phase. From a practical point of view, it is also important to establish a common position before starting the transition and, particularly, before proposing legal amendments. In this context, collaboration between supervisors and central bankers will make a positive contribution to the success of the implementation of the new capital framework.

In Chile, communication and coordination have existed from the beginning of this process and, in 2005, when the transition plan was launched, this was done so jointly by the SBIF and the Central Bank. Subsequently, close communication has been maintained, mainly as regards monitoring the impact on financial stability, and was facilitated because the Central Bank is a member of the coordination committee made up by the heads of Chile's main financial supervisory agencies.

Legal amendments

In some jurisdictions, the implementation of Basel II will require legal changes. Capital requirements are a sensitive matter and have traditionally been set by law. However, considering the complexity of the new capital accord, it is advisable to gain familiarity with its terms and to interact with the industry in order to gather information, knowledge and experience before proposing and passing specific legal amendments. It is also important to remember that such amendments usually take time and remain in place for a period of several years so it will be necessary to determine precisely those points to be established by law and those rules that will be set by the banking supervisor and/or the Central Bank.

This is particularly important given the enormous amount of details and technicalities that the new capital accord involves and the constant changes and innovations that take place in financial markets. It is worth noting that, in Chile, the SBIF has already begun paving the road for the implementation of Basel II by making use of legal powers that allow it to promote good management practices.[18]

Building supervisory capacities

The detail and technicality of Basel II also mean that its implementation poses complex challenges for banking supervisors. As a result, before drawing up a working program for the transition, they would be well advised to create a specialized unit, formed by highly-qualified professionals, to assimilate the contents and scope of the new framework. If the necessary qualifications and skills do not exist internally, they should be provided through training or external recruitment.

The second and, perhaps, most important step is to transfer responsibility for the project to those in charge of field supervision so they can start to incorporate the new ideas and concepts into their day-to-day work. This is a major challenge as it will most certainly imply the adaptation of supervisory methods and procedures, massive training of personnel and cultural changes.

IV. Final remarks

A few months after the final Basel II document was released, Chile's financial authorities announced the country's transition to the new framework for which the Chilean banking industry was considered prepared. After undergoing several structural reforms in the last two decades, the industry appears today fundamentally sound while regulation, supervision and bank management have to a great extent moved into line with international standards and practices. At the same time, the banking sector is well integrated into international markets and its level of activity relative to the size of the economy is high as compared to other developing countries.

All of this is recognized by market analysts and credit rating agencies that rank the Chilean banking industry in a leading position among emerging economies. Nonetheless, a number of challenges will have to be faced in the coming years, including the expansion of banking and financial services to new segments of the population and the promotion of greater efficiency and competition in retail activities.

Preparation for the transition to Basel II has coincided with a process of constant improvement of Chile's regulatory and supervisory framework. In recent years, important developments have taken place that include the update of the loan-classification and provisioning system, the adoption of a risk-based supervisory model, the convergence of local accounting rules with international standards, and the

[18] In Chile, banking regulation envisages the application of a system of solvency classification of institutions that uses the Basel I Capital Index as a benchmark. Institutions with capital indexes equal to or greater than 10% are classified in the top category of the supervisory rating applied by the SBIF.

establishment of new rules for market risks in line with the 1997 Market Risk Amendment.

Although Chile has yet to complete its transition process, some preliminary policy lessons can be drawn from its experience and some of these may be helpful to other developing countries as they seek to address their own implementation challenges. The main lessons can be summarized as follows:

- Prior assessment of the existing state of regulation, supervision and risk management has proved a very useful exercise.

- Serious shortcomings in the implementation of Basel I need to be resolved before moving on to Basel II.

- Improvements to the loan-classification and provisioning system are highly recommendable.

- The competitive and cost implications of the new framework need to be carefully assessed, mainly in the case of small banks.

- Corporate governance and market discipline need to be strengthened.

- Developing countries must be realistic and pragmatic when setting transition plans which means, for most of them, implementing the standardized approach first and moving on later (if at all) to the advanced approaches.

- The use of external ratings poses some difficulties in emerging economies, but this does not preclude implementation of the standardized approach since this offers an alternative option when these ratings are not available or reliable.

- Home/host communication and cooperation are essential for successful implementation but formal arrangements between supervisors, which involve costs for both sides, are only recommendable when foreign banks have a significant or systemic importance in the host market.

- Since most work needs to be carried out by banks, it is crucial they are involved in the transition at an early stage.

- Coordination with the Central Bank is important in countries where regulation and supervision are conducted by different institutions.

- Legal amendments, if required, need thorough preparation and should only be undertaken after some knowledge and experience have been gained and interaction with the industry is well established.

- Implementing Basel II is a major task for banking supervisors so they need to build all the required capacities. This implies, among other measures, recruiting new staff, the training of existing personnel and, in most cases, changing supervisory methods, procedures and culture.

Finally, it is worth mentioning that the current turmoil in credit and financial markets may provide an opportunity to assess some specific policy recommendations of Basel II and to draw new lessons concerning its implementation in both developed countries and emerging economies.

Annex

Table 1: Financial Strength of the Chilean Banking System

(As of December of each year, unless otherwise stated)

Year	ROE	Capital Ratio	Past-Due Ratio	Provisions/Total Loans
1997	13.7%	-	0.97%	1.43%
1998	11.5%	-	1.45%	1.91%
1999	9.40%	13.5%	1.67%	2.53%
2000	12.70%	13.2%	1.73%	2.51%
2001	17.70%	12.7%	1.62%	2.36%
2002	14.40%	14.0%	1.82%	2.33%
2003	16.70%	14.1%	1.63%	2.13%
2004	16.70%	13.5%	1.20%	1.99%
2005	17.85%	13.0%	0.91%	1.61%
2006	18.61%	12.5%	0.75%	1.48%
Jun-07	17.26% [1]	12.6%	0.81%	1.54%

1. For comparison purposes the ROE for June 2007 is annualized

Source: SBIF.

Table 2: Portfolio Composition of the Chilean Banking System

(As of December of each year)

Year	Retail Banking	Corporate Loans	Cross-Border Loans	Foreign-Currency Loans
2004	31.8%	67.2%	1.0%	12.7%
2005	32.8%	66.0%	1.2%	12.3%
2006	33.3%	65.2%	1.5%	13.4%

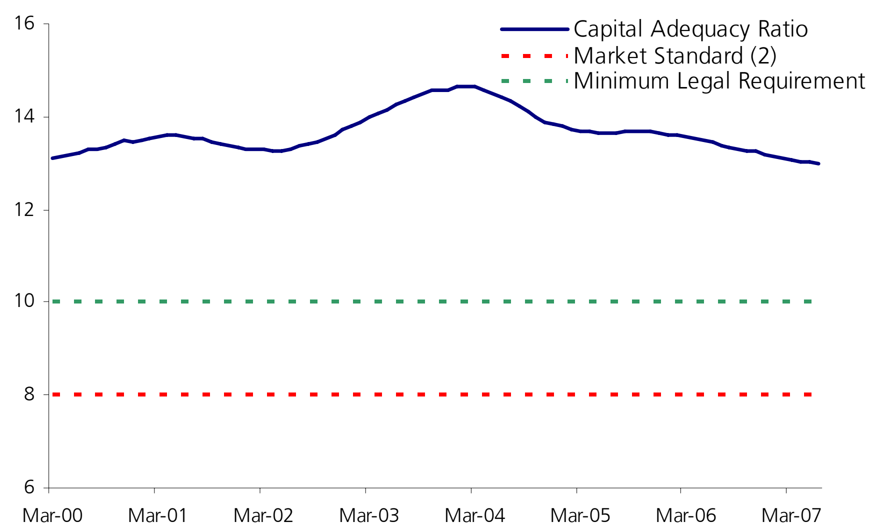
Source: SBIF.

Table 3: Market Structure of the Chilean Banking System
(As of December of each year, unless otherwise stated)

		Share of Loan Market		
Year	**Number of Banks**	**Foreign Banks**	**Domestic Private Banks**	**State- Owned Banks**
1997	29	20.2%	67.9%	12.0%
1998	29	24.8%	62.2%	13.0%
1999	29	41.7%	45.6%	12.8%
2000	29	45.2%	42.6%	12.2%
2001	27	45.1%	42.5%	12.3%
2002	26	42.8%	44.3%	12.9%
2003	26	40.4%	46.3%	13.4%
2004	27	39.5%	47.1%	13.4%
2005	26	38.8%	47.9%	13.3%
2006	26	38.6%	48.1%	13.3%
Jun-07	26	38.6%	48.1%	13.2%

Source: Author's elaboration based on data from SBIF.

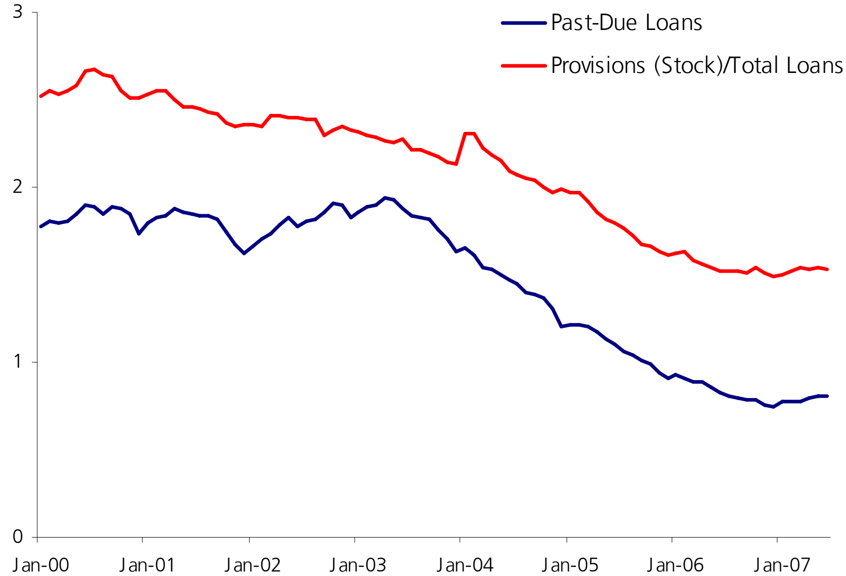
Figure 1: Capital Adequacy Ratio (%) [1]
Chilean Banking System
(Monthly, March 2000-June 2007)



1. Smoothed using 12 m window.
2. This is the level required for a bank to be classified in the top category of the supervisory rating applied by the SBIF. In addition, it is the minimum level required by the *Comisión Clasificadora de Riesgo* (CCR) for pension funds to be allowed to invest in shares issued by a bank.

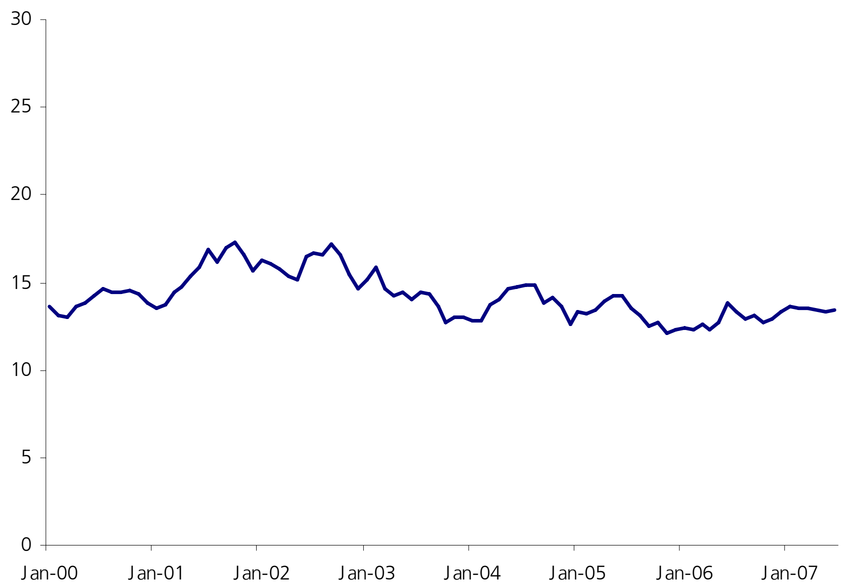
Source: SBIF.

Figure 2: Past-Due Ratio (%)
Chilean Banking System
(Monthly, January 2000-June 2007)



Source: SBIF.

Figure 3: Lending in Foreign Currency as % of Total Lending
Chilean Banking System
(Monthly, January 2000-June 2007)



Source: SBIF.

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