PRESS RELEASE

CMF completes implementation of Basel III regulations in Chile

The Commission issued today regulations for calculating credit, market, and operational risk-weighted assets in banking and on the public disclosure standards related to Pillar 3.

The completion of this regulatory process, started in 2019, is a significant step to strengthen the solvency and stability of the Chilean financial system.

December 1, 2020 – The Financial Market Commission (CMF) issued the regulations to determine the credit, market, and operational risk weighted assets (APRs, for their Spanish acronym) for banks, as well as the Pillar 3 public disclosure standards. With this milestone, the Commission has completed the process of issuing the necessary regulations for the implementation of the Basel III capital framework in Chile.

The new General Banking Act (LGB, for its Spanish acronym), published in January 2019, defined general guidelines for establishing a capital adequacy system in line with international Basel standards, and gave the Commission the authority to establish the capital framework in a prudential manner. The culmination of this regulatory process, which began with the first regulation in public consultation in August 2019, is a significant step to strengthen the solvency and stability of the financial system.

The new capital framework will allow the country to have a more solid and robust banking system, a fundamental condition to face the impacts of the economy's contraction cycles with better tools, and to contribute decisively to the recovery of economic activity. These new standards, while improving the capitalization levels of Chilean banks, also facilitate access to new and better sources of financing, harmonize the requirements between subsidiaries of foreign banks and local banks, and contribute to the internationalization of Chilean banking.

Risk-Weighted Assets

The LGB mandated the CMF to establish standardized methodologies to determine the risk weighting of banking companies' assets as a rule subject to a favorable agreement from the Board of the Central Bank of Chile. It also provided that the

Commission could authorize banks to use their own methodologies to determine risk-weighted assets, an issue that this first version of the regulation restricts to the use of the foundation model for credit risk. Accordingly and in line with the global standards featured in the latest agreement of the Basel Committee on Banking Supervision, and with a prior agreement from the Central Bank of Chile, the Commission issued today Chapters 21-6, 21-7 and 21-8 of its Updated Compilation of Rules for Banks (RAN, for its Spanish acronym). These chapters define the methodologies for calculating credit risk-weighted assets (APRCs), market risk-weighted assets (APRMs) and operational risk weighted assets (APROs), respectively. Furthermore, Chapter 21-20 states the provisions regarding the promotion of market discipline and financial transparency through the disclosure of significant, timely information.

APR Calculation

Prior to the amendment to the LGB, the calculation of APRs was based on the Basel I standard and considered only credit risk, with six categories of assets established in the law. The new standard is more sensitive to credit risk and includes, in addition to credit risk, market and operational risks. The calculation of the APRCs through the standard method is done by setting credit risk weightings (PRCs) by type of counterparty. The APRCs are calculated as the product of the PRC and the exposure net of specific provisions. The applicable PRCs are established by Basel III, except when the calibrations with local data are greater than those proposed by the Committee, in which case the principle of national discretion is used.

Internal models require banks that choose to use them to estimate a set of parameters that reflect their portfolio risks in order to calculate APRCs. To authorize their use, banks must present evidence to the Commission showing compliance with certain minimum requirements and conditions consistent with those outlined in the Compendium of Accounting Standards to compute provisions. The standard allows for a reduction in APRCs by considering credit risk mitigants when a set of general, operational, and legal requirements are met. Among these mitigators are compensation agreements, guarantees and bonds, financial guarantees, and balance sheet compensation.

The Basel III simplified standard model is used for the calculation of APRMs, which stipulates four types of risks: interest rate, foreign currency, stock prices, and commodities. A specific risk is incorporated within the interest rate and stock price risk, aimed at measuring idiosyncratic aspects of the issuer. In the future, the convenience of allowing the use of the new Basel standard model for internationally active banks and internal methodologies will be re-evaluated.

APROs are calculated with the unique standard method allowed by Basel III, which does not support the use of proprietary methodologies. The first component is a business indicator (BIC), prepared with information from the financial statements of each bank and reflecting the scale of operations of the institution. The second component is an adjustment factor based on the operating losses incurred by the institution over the last 10 years (ILM).

Pillar 3

The aim of the local Pillar 3 regulatory proposal is to allow the market to know risk profiles of local banking institutions, including their position and capital structure (at a local consolidated and global consolidated level) in a unified format. This allows a better analysis while reducing information asymmetries among market agents.

Banking entities must publish their Pillar 3 document independently or alongside their financial statements, reporting each of the tables and forms established in the regulation. The documentation, which must be easily identifiable and accessible, will be published on each bank's website. The information requirements established in said regulation will apply to all banks incorporated in Chile and branches of foreign banks operating in the local market.

Implementation

In March 2019 the CMF, in coordination with the Central Bank of Chile and in line with the measures adopted by regulators at the international level, decided to postpone by one year the implementation of the calculation of APRs and to provisionally keep the general regulatory framework in force until November 30, 2021. Additionally, it decided to advance a capital mitigation mechanism in the transitory credit risk standard to facilitate the development of the debt pacts market. This was due to the Covid-19 contingency and supplements a similar treatment of state guarantees already granted by the Commission this year. As for Pillar 3, its implementation was postponed until 2023.

Impact

With data as of December 2019, it is estimated that APRCs would decrease by 23 percent compared to the current figures. However, the inclusion of APRMs and APROs partially compensates for this reduction at a systemic level. Considering all three risks, APRs decrease by 9 percent, which is equivalent to capital savings of USD 1.43 billion.

In the case of Pillar 3, the main costs fall on the development of new information systems, whose demand has been postponed until the new standards of Pillars 1 and 2 are already implemented.

To access the details of said regulations, interested parties can visit the Rules and Norms section of the CMF website. The Commission also makes available Regulatory Reports that evaluate the impacts of these proposals, Frequently Asked Questions documents, and their respective Presentations. All these elements summarize the core elements of each regulation.

Area of Communications, Education, and Image – Financial Market Commission (CMF)

Contact: prensa@cmfchile.cl | Press Room

@CMFChile_

@CMF_Educa

@CMF_HEsenciales

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