Chilean Banks to Basel III

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October 11th, 2018

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1 Banking Law Reform Framework

Banks Prudential Regulations

Pilar	Problem	Solution
Capital Requirements	In a crisis context, the costs derived from the investment decisions of the banks are absorbed by the depositors and the state instead of the shareholders	By requiring that the bank's activities be financed with a greater proportion of capital, the owners of the bank internalize the costs associated with their investment decisions and absorb the losses they may generate.
Supervision Authority	Depositors are not able to adequately monitor the activities of banking institutions	A regulator who has the adequate capacities and independence to effectively supervise banking institutions. This supervisor must be able to identify risks that may call into question the ability of banks to meet their creditors
Banks with Problems	Systemically important banks that present insolvency problems could produce a cut in the payment chain or infect the rest of the financial system	The regulator can define tools that allow to adequately handle, and preventively, the financial problems of banking institutions, thus avoiding insolvency

Basel Committee Standards

Basel I (1988)

First international standard on capital adequacy for banks:

• A minimum capital ratio to risk-weighted assets of 8% is established, incorporating credit risk.

• In 1996, market risk is included in the estimation of risk-weighted assets (APR).

Basel II (2004)

Introduced three pillars:

• Pillar I: Minimum capital requirements, incorporating operational risk; allows internal models for calculating credit risk (weights).

• Pillar II: Quantification of the supervisor of the capital needs according to the bank's risks, and includes 16 principles.

• Pillar III: Strengthen market discipline through the dissemination of information and promote good banking practices.

Basel III (2010)

More and better capital:

• Increase in the proportion of instruments that better absorb losses (perpetual bonds over subordinated bonds).

• Capital conservation buffer.

• Capital counter-cyclical buffer.

• Additional capital requirements for systemic banks.

• Leverage and liquidity requirements.

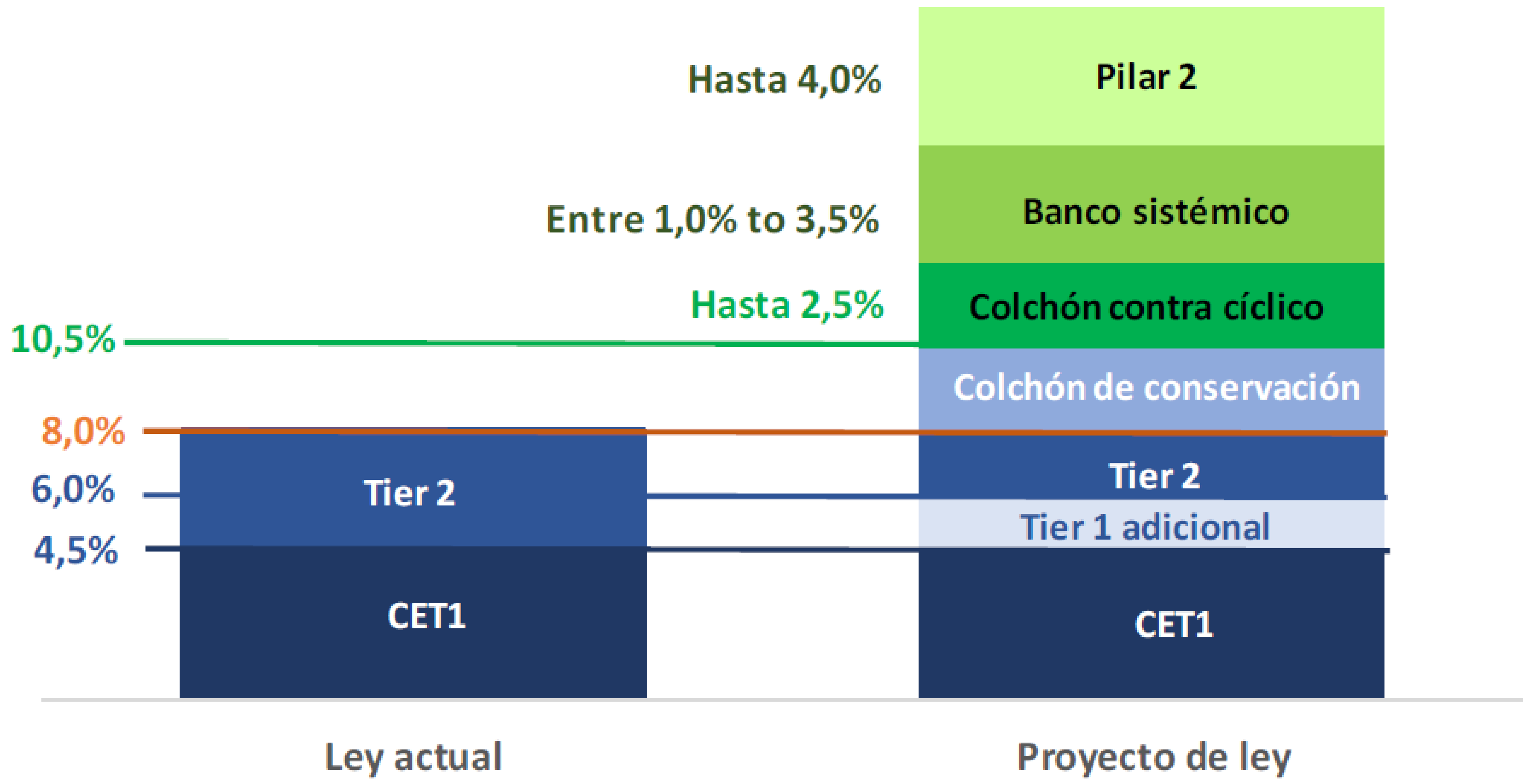
• Greater demands on the issue of capital deductions.

• Encourage the use of centralized negotiation mechanisms for OTC derivatives.

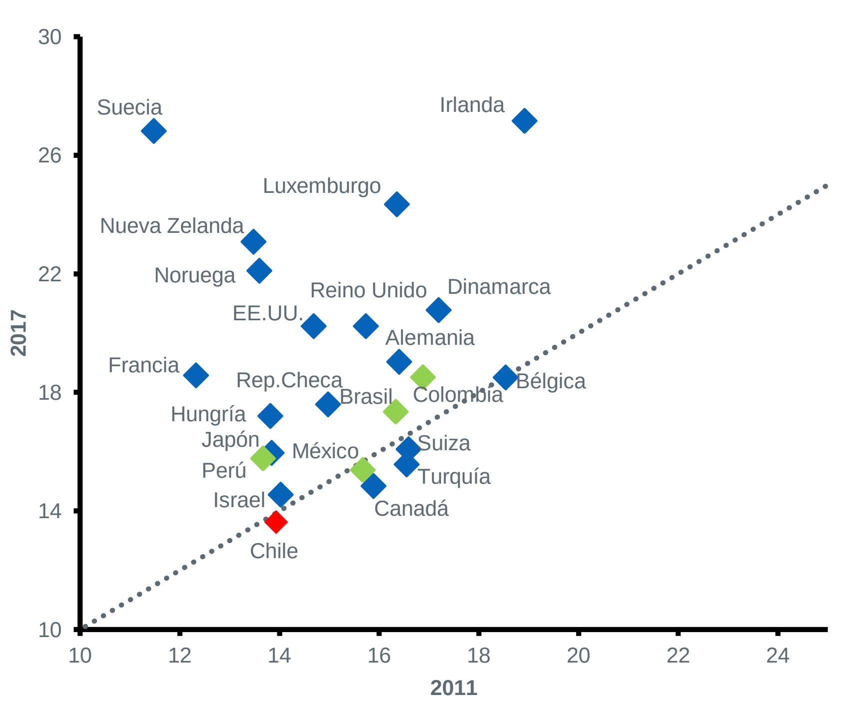
Chilean Banking Act Reform Highlights

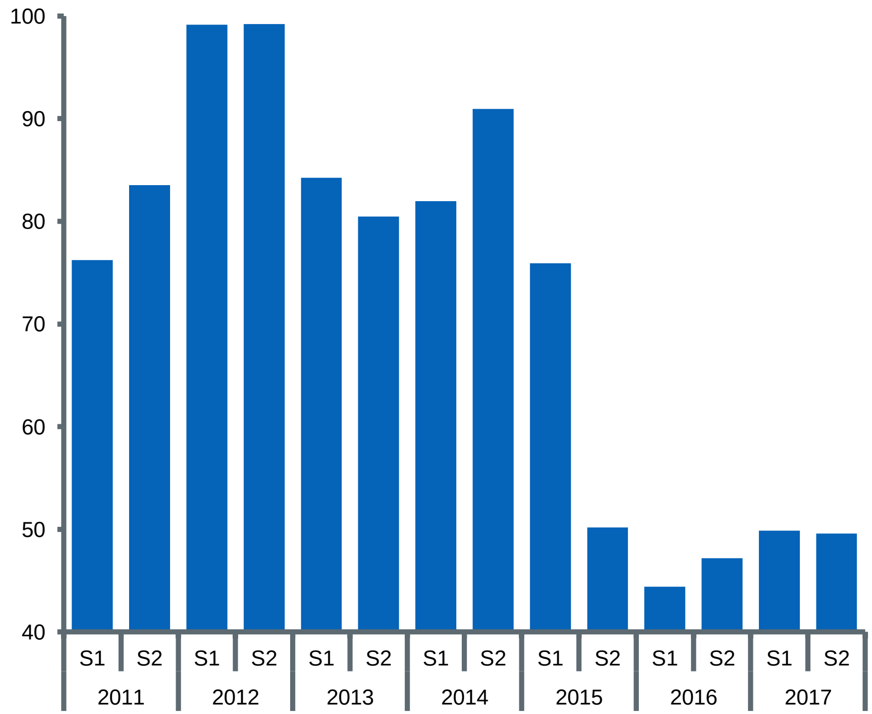
Main Objectives	Change Proposal
1. Improve capital requirements	1. Basel III gradual implementation
2. Strengthen financial supervision and regulators attributions	2. Integrate banking regulation and supervision within the FMC
3. Provide the regulator with tools for the management of banks with problem	3. Creation of early regularization plans

Basel III Capital Requirement vs Basel I



Capital Adequacy Benchmark – Financial Stability Report





Capital adequacy indicator by country (*).

Green markers highlight Latin American countries. Annual data.

Source: Central Bank of Chile based on information from the IMF.

Banks with capital ratio equal to or greater than 10% under severe stress scenario (*).

(*) As of % of total system assets.

Source: Central Bank of Chile based on information from the SBIF.

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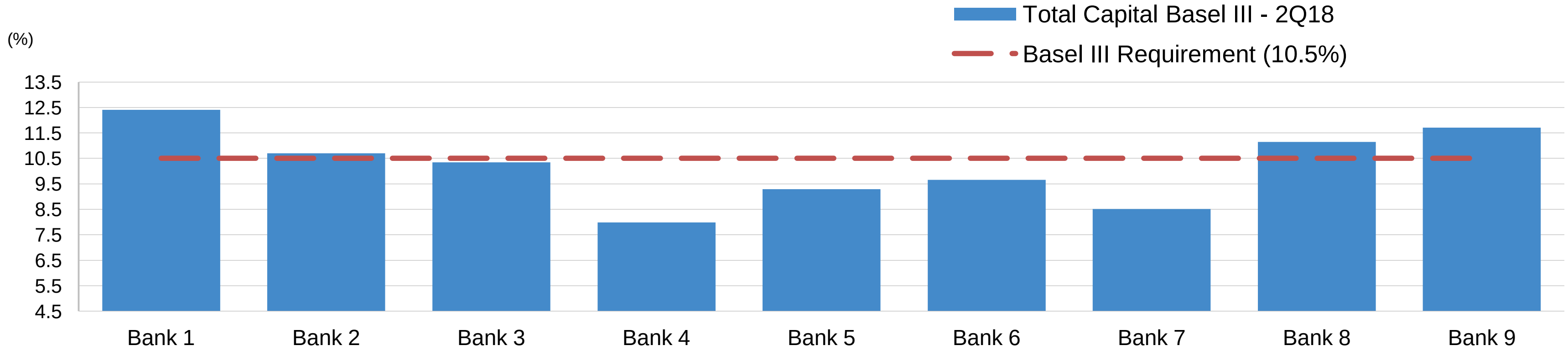
2 Fitch Ratings Opinion

General Banking Law Reform Will Strengthen System

Proposed changes to the Chilean General Banking Law will bring it in line with Basel III recommendations and is supportive of banking system stability. The reforms would raise regulatory capital requirements and strengthen the regulatory and resolution framework. Fitch believes that this will strengthen the regulator's governance and autonomy. The reform adds the Superintendency of Banks role to the recently created Financial Market Commission (FMC).

Chile's banking sector is generally well positioned to implement the new capital requirements that are part of the reform. However, the degree that it will enhance stability will depend on the final scope and timeframe of implementation, as well as whether it incorporates lessons learned in other emerging markets. Midsized EM banks have struggled to raise capital through domestic Additional Tier 1 (AT1) capital instruments and also have been unable to raise AT1 capital in international markets.

Basel III Ratio/Adjusted Risk Weighted Assets



Total Capital: Defines as common equity T1+AT1+T2. Adjusted RWA excluded goodwill, intangibles and DTA.
Adjusted RWA: include credit and market RWA under standarized model; operational risk Fitch's estimation.
Source: Fitch calculations under regulatory reports.

Banking Act Reform

- Total minimum regulatory capital will be 10.5% of RWA, up from the current 8%.
- New 2.5% conservation buffer of common equity.
- Changes include increasing the Tier I capital minimum to at least 6% of RWA, composed of a minimum 4.5% of core Tier I plus 1.5% of AT1, previously undefined Tier I capital instruments.
- Tier II capital will drop to 2% from the current 3.5% of RWA and includes voluntary reserves.
- A countercyclical buffer of up to 2.5% of RWA would also be added, to be determined by the central bank with FMC agreement.
- The D-SIB capital charges (1% to 3.5% additional capital) would be determined by the FMC with central bank approval.
- The reform introduces Pillar II risk management and supervision recommendations, up to 4% of additional capital for specific banks (subject to the approval by 4/5 members of FMC).

Changes of Capital Requirement

	Current Law	Basel III
Common Equity Tier 1 (CET1)	4.5%	4.5%
Additional Tier 1 (AT1)	_	1.5%
Tier 2 (CET2)	3.5%	2.0%
Regulatory Capital	**8.0%**	**8.0%**
Conservation buffer	_	2.5%
Capital minimum requirement	***8.0%***	***10.5%***
Countercyclical buffer	_	Up to 2.5%
D-SIBs	Up to 6%	Up to 3.5%
Pilar II	_	*Up to 4.0%*

Source: General Banking Act Reform

Changes of RWA Ponderation

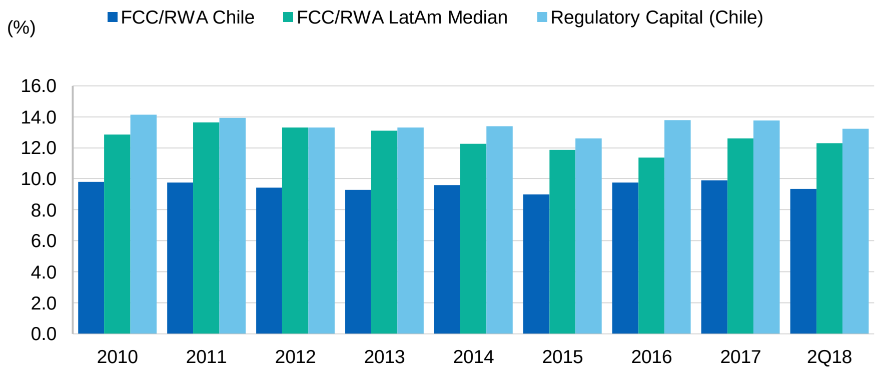
Asset Type	Definitions	Current Law (RWA)	Basel III (RWA)
Category 1	Cash; deposits with the central bank and approved financial institutions	0%	0%
Category 2	Financial instruments issued or guaranteed by the state of Chile	10%	0%
Category 3	Irrevocable letters of credit for foreign trade issued by foreign banks with a minimum rating of A–	20%	0% to 100% (intl' ratings consideration)
Category 4	Home mortgage loans	60%	35% to 75%
Category 5	Physical fixed asset, other financial assets and all the other assets not included in the previous categories	100%	From 75% to 100% or high

Source: General Banking Act Reform

Banking Act Reform

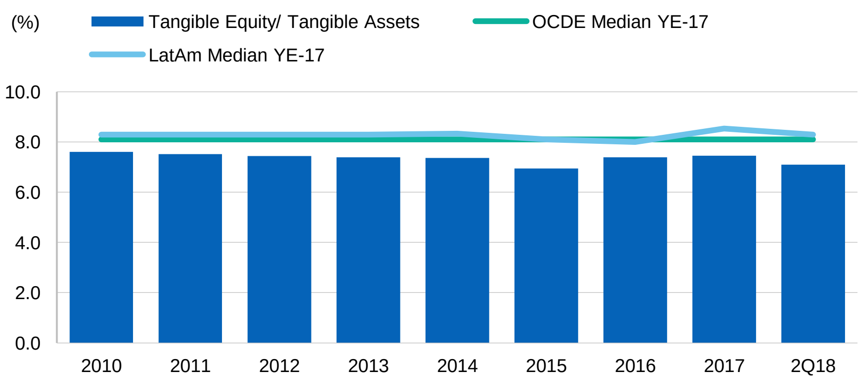
- The current definition of RWAs will extend to include market and operational risk and capital deductions would include those stated in Basel III definitions (goodwill, intangibles, DTA, etc.).
- Those will be defined into next 18 months once the FMC absorbed the SBIF. Regulator had suggested to adapt Basel III ponderations to the local market and the use of internal model will be on a slow pace.
- New restrictions to dividend pay-out policy if the conservation buffer drop below 10.5%. Also, if AT1 instruments were writte-down.
- Banks should modify their dividend/profit-reinvestment policies to meet the capital requirements, depending on the pace and extent of Basel III implementation.
- New early regularization tools to prevent banks failure, easily activated by the FMC and subject to warnings defined in the new law.

FCC/FCC-Adjusted RWA



Source: Fitch calculations under regulatory reports.

Tangible Common Equity/ Tangible Assets

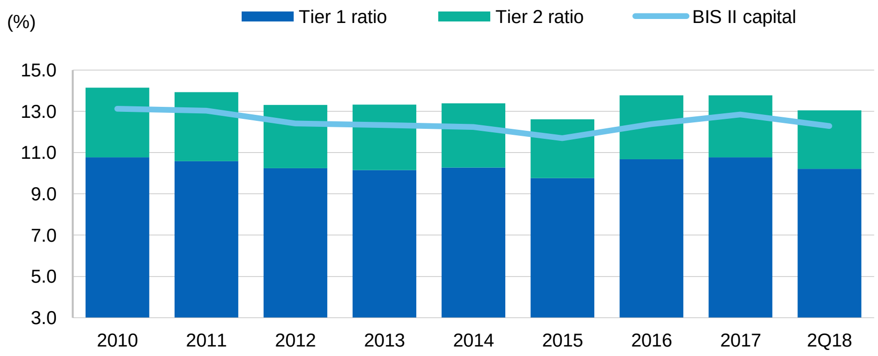


Source: Fitch calculations under regulatory reports. Exclude goodwill, intangibles and differed tax assets.

Transition Period

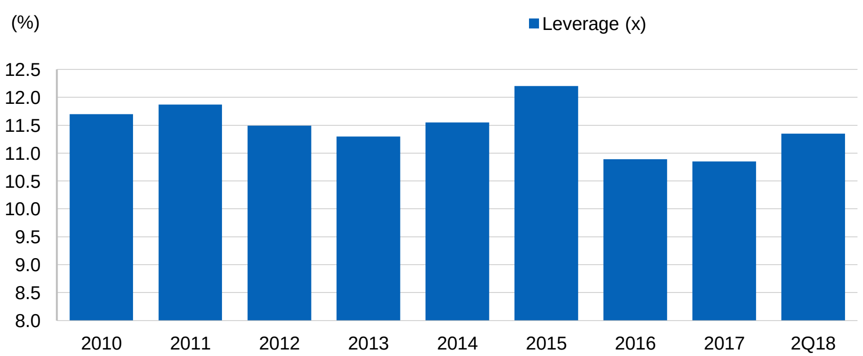
- Banks will have six years to comply with the new capital standards, once the FMC has absorbed SBIF.
- The regulator estimates that USD2.800 million-USD4.000 million of additional capital will need to be raised from 2019-2024. This does not include the countercyclical buffer or the additional capital charges for domestic systemically important banks (D-SIBs).
- If the banks maximize the use of new AT1 capital instruments, which are allowed in the reform, and the risk weighted assets treatment become more similar to Basel III or if mitigants are allowed, the costs should be nearer to the lower end of the estimate.
- However, AT1 instruments do not yet exist in the local capital markets, and the ability and willingness of Chilean banks to explore the global market for issuing these securities is uncertain.

Regulatory Capital Disclosure



Source: Fitch calculations under regulatory reports.
BIS II include credit and market RWA under standarized model.

Banking System Leverage



Leverage calculated as: (total assets-equity)/common equity.
Source: Fitch calculations under regulatory reports.

Transition Period

Basel III: Progressive Implementation (2019-2024)

	T_0 (1)	T_1 (2)	$T_1 + 1$	$T_1 + 2$	$T_1 + 3$	$T_1 + 4$
Regulatory Capital (floors)						
CET1 (3)	4.5	4.5	4.5	4.5	4.5	4.5
CET1+AT1 (4)	4.5	-	-	5.0	5.5	6.0
CET1+AT1+T2	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**	**8.0**
Buffers (top limit)						
Conservation			0.625	1.25	1.875	2.5
Counter-cyclical			0.625	1.25	1.875	2.5
D-SIB (5)			0.625	1.25	2.375	3.5
Pilar II			**4.0**	**4.0**	**4.0**	**4.0**
Leverage						
General	3.0	3.0	3.0	3.0	3.0	3.0
D-SIB	**3.0**	**3.0**	**3.5**	**4.0**	**4.5**	**5.0**

(1) T_0: first year ended since law approval (2018); (2) T_1: regulatory framework to be issued by CMF (máx 18 months from T_0 = 2020)

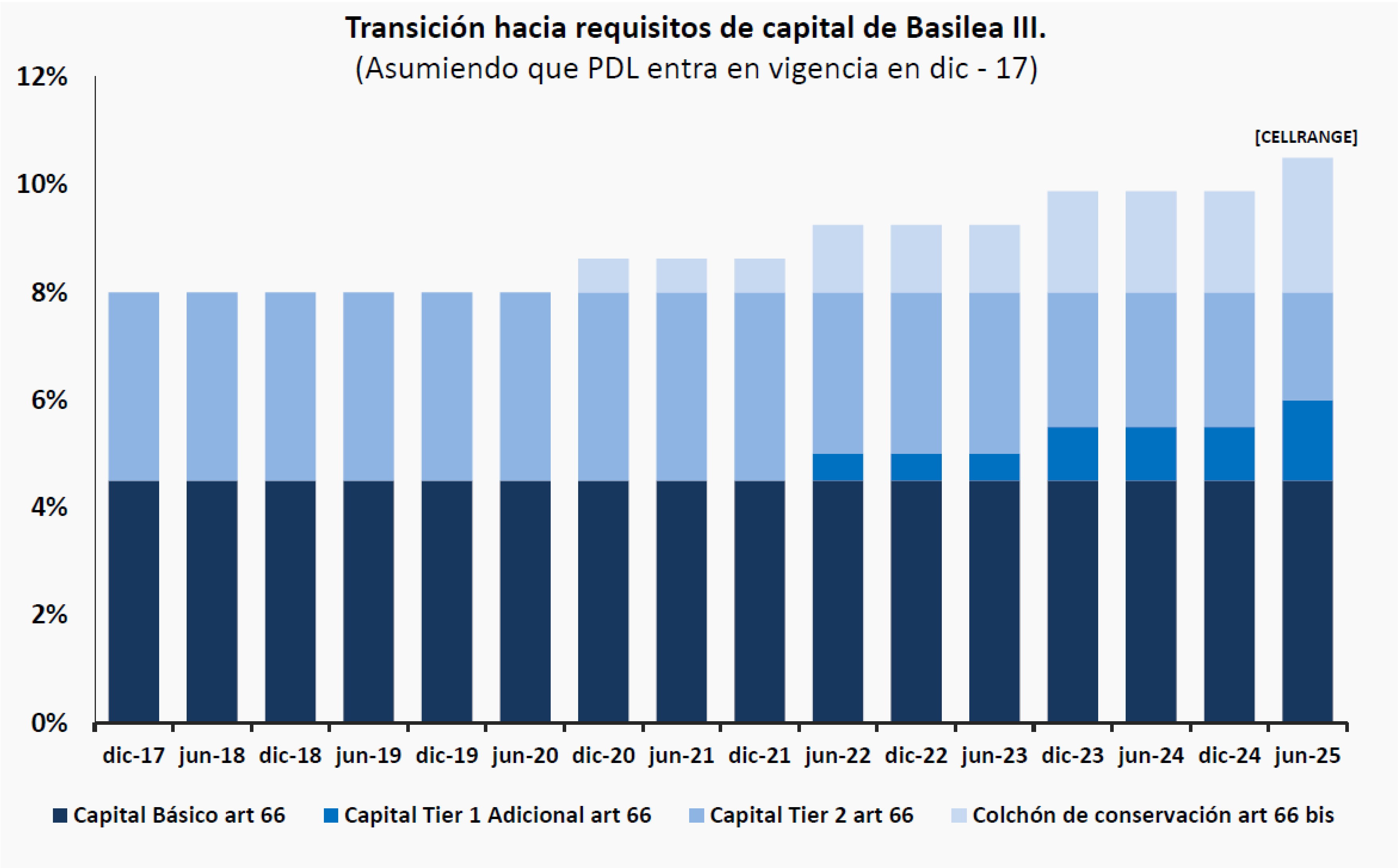
(3) Capital deductions (goodwill, intangibles, DTA) will be implemented on a progressive basis (4 years according capital increases)

(4) AT1 instruments are allowed to be compliance with T2 (subordinated and additional reserves) during first 3 years since T_0

(5) Current law D-SIB is about 3% and may be up to 6% for relevant market concentration. New law limit is up to 3.5%.

Source. Bank regulatory authority

Transition Period



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