

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This annex contains detailed assessments of Chile's observance of three international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory framework in Chile is adequate to address the potential risks in the financial system, as well as the strength of the underlying regulatory governance practices and market foundations, and the functioning of market infrastructure. The assessments have provided the basis for making recommendations for further strengthening of the institutional, legislative and regulatory aspects of the Chilean financial stability framework.

The Financial System Stability Assessment (FSSA) is based on the work of the joint IMF-World Bank FSAP missions to Chile in December 2003 and March 2004 co-led by Messrs. Ize (IMF) and de la Torre (WB). The FSAP assessors are as follows: Messrs. Brian Quinn (formerly Bank of England) and Juan Ortiz (WB/Bank of Spain) for the *Basel Core Principles for Effective Banking Supervision*; Jonathan Katz (U.S. SEC) for the *IOSCO Objectives and Principles of Securities Regulation*; and; Ms. Marie Thérèse Camilleri (IMF) for the *IMF Code of Good Practices on Transparency in Monetary Policies*.

The assessments were preceded by self-assessments undertaken by Chilean authorities, which were evaluated during the FSAP, by focusing on actual practices and verified through discussion with Chilean authorities, market participants, and industry associations.

Chile's observance of international financial sector standards and codes is very strong, even though in each area, certain aspects were identified where further improvements would be desirable. The Chilean authorities are well aware of the areas that need further reforms and are in the process of addressing them.

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

52. The assessment is based on several sources: (i) the legal and regulatory framework, contained mainly in the Banking Law (*Ley General Bancaria*, LGB); in regulations issued by the BCCh and the SBIF, which are compiled in two compendia (*Compendio de Normas Financieras* and *Recopilación Actualizada de Normas*); and (ii) examination of key documents and discussions with SBIF senior staff; (iii) discussions with relevant government agencies, as well as bankers, auditors, and rating agencies; and (iv) the assessment report on Chile's observance of the Core Principles, prepared by external consultants in February, 2000. The assessors benefited from the full cooperation of the Chilean authorities and received all information necessary for the assessment.

B. Main Findings

Introduction

53. The supervisory regime is well established and enjoys a reputation, both inside and outside the banking community, for good technical skills and for integrity. The lessons of the banking crisis of the early 1980s are well embedded, but there has been a conscious policy of moving away from a hands-on, compliance-driven style towards one that places increasing responsibility for prudent conduct on the boards of directors and senior management of the banks. There has been a correspondingly greater emphasis on corporate governance. This transition has increased the need for the banks to further strengthen their risk management, and the need for the supervisors to develop further the current risk-oriented supervisory approach, where appropriate training and IT capacities are paramount.

54. The Superintendency is already managing some of these developments and appears to be doing it effectively. In particular, the policy of placing greater responsibility on bank boards and management for the prudent conduct of the bank is both consistent with international best practice, and is being reflected in changes in the legal and regulatory framework. The banks are conscious of this change in approach and appear to be equipping themselves to implement it. This shift in emphasis may lead to more active and adventurous behavior by banks and to pressure for the formation of a larger number of broader financial services groups which contain banks. If so, consideration should be given to a strengthened legal framework if these changes are to take place without endangering stability.

55. Chilean accounting norms for banks depart in a number of respects from international standards. These differences include accounting for credit limits and other underwritings, as well as accounting for NPLs and reserves for loan losses. From a prudential viewpoint this does not appear to be a significant issue, as supervisory requirements for provisions for bad and doubtful debts, and for write-offs, appear to be prudent and carefully monitored. However, comparison with the published accounts of banks in other countries employing

international standards is difficult and raises unnecessary questions about the relative safety and soundness of Chilean banks.

Objectives, Autonomy, Powers, and Resources (BCP 1)

56. Notwithstanding a strong supervisory culture, some of the institutional arrangements for banking supervision are flawed and should be strengthened. Although the SBIF is legally established by the Banking Act, the Superintendent is appointed by the President of Chile, has no fixed term of appointment, and may be dismissed by him without cause; it is customary for the Superintendent's term of office to coincide with that of the President, a practice which carries the risk of politicizing the office.

57. The SBIF staff do not enjoy the same job-security available to other public servants. They are appointed by the Superintendent and may be dismissed by him personally without reason other than the general grounds of failure to perform their duties. That said, staff numbers at the SBIF appear to be stable and morale is good.

58. The SBIF has little control over its financial resources. These are derived from a levy on commercial banks, divided equally between the budget of the SBIF, which has to be approved by the MoF, and the Ministry itself. In practice, the SBIF appears to have sufficient funds its needs, including adequate numbers of well-trained staff. However, the current system not only puts this at risk by its informal nature, but also obscures the efficiency with which this effective tax on banks is used.

59. The legal protection available to SBIF officials in discharging their duties appears to be limited to protection against physical abuse or defamation arising from the performance of their duties. Supervisory staff are subject to civil legal action for negligence and there is doubt whether they could receive financial support in defending themselves in such actions. The penalties that supervisory staff may therefore incur could encourage a compliance-based style that contradicts with the current efforts to provide incentives to the commercial banks to take greater responsibility for their affairs. It is possible that the exercise of greater discretion by bank supervisors to encourage this change in behavior by banks' management could expose supervisors to an increased probability of legal pursuit. This could, over time, affect the SBIF's efforts to attract and retain quality staff.

60. Greater autonomy for the SBIF and increased legal protection for supervisors should be accompanied by greater accountability. The precise institutions and machinery required to deliver this additional accountability would be for the government to determine, but might include some combination of enhanced internal controls and independent professional external scrutiny. Improved governance for the SBIF should, if properly designed and executed, further enhance the reputation which it already enjoys.

61. Further consideration should also be given to redefining the role and objectives of the SBIF. Currently the SBIF is the sole agency with powers to grant banking licenses, and normally does so after receiving a formal opinion from the BCCCh. However, the SBIF can

withdraw a license only with the prior approval of the BCCh. While the Banking Act is administered by the SBIF, the issuance of many regulations governing prudential requirements on banks is the responsibility of the BCCh. On the other hand, the SBIF has adopted the mission of ensuring public confidence in the banking system, a task that falls in many countries to the central bank or, at least, is shared with it.

62. These arrangements are untidy and, more importantly, weaken the authority of the SBIF. While it is acknowledged that the BCCh has an important stake in maintaining the stability of the banking system, most notably as guarantor of certain bank deposits, it would be greatly preferable to confine the responsibility of the SBIF to the prudential regulation of institutions authorized to conduct banking business; and to give it the powers to carry out this task in all respects: issuing regulations, licensing and supervising banks and applying the necessary sanctions, including withdrawing licenses after consultation with the BCCh.

63. Co-ordination and co-operation among the various supervisory and regulatory agencies is working effectively, but needs to remain abreast of developments in the financial sector. The SBIF meets with other agencies at the Superintendents' Committees, with the BCCh and the MoF also present in the Capital Markets Committee. These arrangements appear to work well and would probably continue to do so as long as the financial landscape remained unchanged. However, as financial goods and services are increasingly spilling over institutional and regulatory boundaries, as has commonly happened abroad, new arrangements may well be needed, including clear formal arrangements for defining responsibilities, for framing regulations, for information sharing, and for acting in an emergency. This could be done via MOUs and formal terms of reference for the Superintendents' Committee that would close potential gaps in the supervisory net, and avoid ambiguity in the agencies' responsibilities. The appointment of a lead regulator or coordinator for meetings of the Superintendents' Committee, supported by a small secretariat and the definition of its terms of reference, also should be considered.

Licensing and Structure (BCPs 2-5)

64. Present framework enables the SBIF to assess the ownership structure of banking organizations, including the banks' direct or indirect controlling shareholders, as well as the operations and strategies proposed for the bank. While the law empowers the SBIF to apply a fit and proper test to applicants for a banking license, the criteria are limited to financial solvency and moral integrity, and do not include experience or expertise in banking or financial management appropriate to the activities of the bank. The SBIF carries out checks on the competence and experience of controllers of banks but this is done on an informal, and therefore legally doubtful basis.

Prudential Regulation and Requirements (BCPs 6-15)

65. Chilean financial institutions must maintain a minimum level of capital with respect to their risk-weighted assets and other commitments in line with the Basel Capital Accord, but are not required to maintain capital against market risks. On January 2004, a new

regulation for the grading of loans and the determination of the provisions for loan losses entered into effect. The new system is inspired by the Basel II model and employs ten loan grades. The Chilean supervisory authorities have adopted a conscious policy of placing increasing responsibility on management, enhancing thus managerial practices and internal controls. AML/CFT legislation has recently been materially strengthened, supporting the efforts of the SBIF to encourage supervised institutions to implement KYC rules.

Methods of Ongoing Banking Supervision (BCPs 16 – 20)

66. The supervisory model of the SBIF is comprehensive but its scope needs to be extended to permit the identification of all the risks in a group, whether they lay within the banking group or in an affiliated company. The SBIF can perform on-site examinations on all institutions within a banking group, including their subsidiaries at home and abroad. Off-site supervision is based on the financial information and reports submitted by banks to the SBIF, on the results of on-site inspections, on internal and external auditors' reports, and public information. The scope of consolidated supervision under the current law ends at the level of the bank holding company and therefore fails to capture risks in other parts of a broader group that could endanger the bank. Other companies outside the banking group, which are associated through common directors or a common name, may create risks for the bank which could threaten the interests of depositors if difficulties should arise in these companies. Supervisors should therefore have the powers to obtain any such information through the authorized bank. Controllers of the bank holding company are requested to provide information on their financial position and on their other interests outside the bank; but they are not obliged to do so, even if requested by the SBIF.

Information Requirements (BCP 21)

67. The audited financial statements of banks do not follow closely internationally accepted practices and standards, hindering comparison with other countries. However, these differences do not raise any particular prudential concerns.

Formal Powers of Supervisors (BCP 22)

68. The legal framework grants the SBIF sufficient and comprehensive powers for prompt corrective action, through either rehabilitation procedures or closure and liquidation. In addition, supervisors have at their disposal a broad range of powers that are available to impose graduated remedial actions.

Cross-Border Banking (BCPs 23 – 25)

69. The SBIF has the authority to perform global consolidated supervision and to share information with foreign supervisors. The SBIF has signed MOUs with relevant foreign supervisory authorities.

C. Recommended Action Plan and Authorities' Response to the Assessment

Recommended Action Plan to Improve Compliance of the Basel Core Principles

Subject	Recommended Action
Objectives, Autonomy, Powers, and Resources (BCP 1)	<p>Strengthen the institutional arrangements of banking (and financial sector) supervision. At a minimum, the law should (i) establish full operational independence of the SBIF, including new provisions for the appointment for a minimum—non coincident with the President's—term for the Superintendent; (ii) ensure adequate legal protection for supervisors when discharging their duties in good faith; (iii) establish a separate budget for the SBIF; and (iv) strengthen the employment conditions of the staff of the SBIF to protect them against undue dismissal.</p> <p>These reforms should be matched by enhanced accountability on the part of the SBIF. In this respect, it could be useful to introduce a quality control mechanism for the continuous monitoring of supervisors' work.</p>
Licensing and Structure (BCPs 2-5)	Empower the SBIF, in both the licensing and the ongoing supervisory processes, to reject and withdraw licenses and to prevent the appointment of directors and senior managers, as well as controlling shareholders, that do not have the proper skills expertise.
Prudential Regulations and Requirements (BCPs 6- 15)	<p>Speed up the introduction of market risks regulations to include capital charges for these risks.</p> <p>Expedite the provision of means to the FIU to rapidly achieve observance of the AML/CFT laws and regulations. Define the role of financial sector supervisors in AML/CFT matters.</p>
Methods of Ongoing Supervision (BCPs 16-20)	<p>Enlarge the scope of consolidated supervision, including clear coordination mechanisms and clear rules for the determination of the lead supervisor or coordinator for financial conglomerates.</p> <p>Require a single external auditor for the whole group.</p>
Information Requirements (BCP 21)	Expedite the adoption of IASs.
Formal Powers of Supervisors (BCP 22)	Expand bank resolution options available for the SBIF.

Authorities' response

70. The Chilean authorities indicated that they assign a high priority to complying with best practices regarding money laundering. In their opinion, the assessment of Principle 15 regarding Money Laundering did not reflect the improvements that have taken place during the last few months. In December 2003 a law was enacted that created a specialized agency to prevent Money Laundering, the Financial Analysis Unit (UAF). The UAF is performing its

duties normally. Since May 2004, it is mandatory for banks, their subsidiaries, and the savings and loans cooperatives to report on suspicious transactions and to comply with strict "know-your-customer rules" procedures.