



Two new Basel III regulations

CMF publishes for consultation regulations on determining credit risk-weighted assets in banking and the framework for implementing capital buffers

A standardized methodology and the principles for the use of internal methodologies are presented for the determination of credit risk-weighted assets.

The regulation on capital buffers defines procedures for calculation, implementation, and supervision of additional capital requirements that will be gradually applied to banks in Chile starting in December 2021.

January 27, 2020

The Financial Market Commission (CMF) has started a public consultation process on two new regulations concerning the adoption process of Basel III Standards by local banks. Said regulations address the methodology for determining credit risk-weighted assets (APRCs, for their Spanish acronym) and the assessment of compliance with capital buffers.

By publishing these two new regulations for public consultation, the CMF remains on schedule for issuing all the regulations needed to implement Basel III in Chile. The new regulations will become effective on December 1, 2020.

Credit Risk-Weighted Assets

Regarding **the methodology on the determination of APRCs**, the proposal follows the stipulations of Article 67 of the General Banking Act (LGB, for its Spanish Acronym) and the latest agreement of the Basel Committee on Banking Supervision (Basel III). This proposal will be on public consultation until April 15, 2020.

The Basel Committee on Banking Supervision (BCBS) defines credit risk (CR) as the risk that a debtor or banking counterparty will not meet its obligations in accordance with the agreed terms.

Credit risk is the most relevant one in the traditional banking industry and therefore was the first to be considered in the Basel Accords. The subprime crisis highlighted its relevance with the significant reduction in credit risk-weighted assets, facilitated using internal models and its consequences on the strength of bank portfolios.

The Basel III Accord, published in 2010 and revised in 2017, introduced adjustments to standard and internal methodologies, as well as establishing regulatory floors for both the determination of risk parameters and the overall risk-weighted assets basis.

APRC Methodologies

In accordance with Article 67 of the LGB, the CMF's regulatory proposal presents a standard methodology (SM) and principles for the use of internal methodologies (IMs) to determine credit risk-weighted assets by banks operating in Chile.

The current mechanism estimates APRCs using a methodology grounded in the Basel I standard. It only distinguishes five categories of assets and doesn't allow the use of internal methodologies or techniques to mitigate exposure by collaterals or qualified guarantors. In contrast, the standardized approach proposed with the Basel III standards is more risk-sensitive, as it has categories that depend on the type of counterparty and different risk factors.

Such categories are not based on accounting criteria, but rather on the underlying risk. Accordingly, all mortgage-backed exposures --e.g. housing loans-- are treated differently from non-mortgage-backed exposures, regardless of the portfolio type. Furthermore, in the case of mortgage-backed exposures, there will be different types of treatment depending on the type of real estate and whether the obligations are paid with income generated by the property itself.

The new framework will also allow the use of IMs subject to the fulfilment of minimum requirements. The standard under consultation also proposes the possibility of reducing APRCs by considering credit risk mitigants such as netting agreements, guarantors, collaterals, financial guarantees, and balance sheet compensations.

Impact

With data as of December 2018, it is estimated that APRCs would decrease by 23 percent compared to those calculated under the current standard. That would be equivalent to USD 4.5 billion on capital savings. However, such a gap would be offset by the inclusion of market and operational risk-weighted assets.

The regulation will become effective and must be implemented starting on December 1, 2020.

Capital Buffers

In addition, the CMF has published for consultation until March 31, 2020 a regulatory proposal for the assessment of compliance with capital buffers. This is in accordance with Articles 66 bis and 66 ter of the LGB and the latest agreement of the BCBS.

Capital buffers are an additional capital requirement over the legal minimum set by the LGB and are divided into two types: a conservation buffer (CCoB) and a countercyclical buffer (CCyB).

According to the regulatory proposal, the CCoB is a fixed amount equivalent to 2.5 percent of the risk-weighted assets (APR, for their Spanish acronym) after excluding mandatory provisions. Although the CCoB is of a permanent nature, it is expected to be used when the bank faces the materialization of idiosyncratic or systemic risks, thus avoiding default and credit supply contraction.

Meanwhile, the CCyB is a variable amount ranging from 0 to 2.5 percent of the net APRs after excluding mandatory provisions. The CCyB is established when there is an expansive phase of credit --associated to the accumulation of systemic risks-- while its release occurs when such risks dissipate or materialize, whichever comes first. Banks must comply with this buffer to achieve an A solvency rating.

The Central Bank of Chile (BCCh, for its Spanish initials) is responsible for activating the countercyclical buffer based on a favorable report by the Commission. An agreement by the BCCh's Board will determine the additional core capital requirements to be imposed on all banking companies incorporated or authorized to operate in Chile. It will also explicitly define the timeframe that banks will have to fulfill the requirement. Said timeframe may not be less than six months counting from the agreement's publication.

Under the same procedure, the BCCh will determine the deactivation of the countercyclical buffer and its implementation period.

Requirements

The additional capital required for banking companies under this standard will be the sum of both buffers. In the event of a deficit, banks must restrict the payment of dividends, and the purchase of their shares by controlling shareholders is prohibited unless approved by the CMF.

The implementation of the regulation considers a four-year transition period. From December 1, 2021, the maximum value of both the CCoB and CCyB will be 0.625 percent each. The threshold will be raised by the same amount in 2022 until reaching full implementation in 2024.

It is preliminarily estimated that the new regulations would require additional capital requirements of USD 2.05 billion. Considering their transitory nature, the increased CCoB requirement will begin on the third year, providing banks with temporary leeway to comply with all new demands.

To access the details of the regulatory proposals, you can visit the [Draft Rules and Norms](#) section of the CMF website. In addition, the Commission also makes available to interested parties a Regulatory Report evaluating the impact of these proposals, a Frequently Asked Questions document, and a Presentation. These documents summarize the core elements of this public consultation.

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