

# ABOUT THE CHALLENGES TO REGULATE THE BANKING ACTIVITY AND THE NEW LEGAL FRAMEWORK FOR BANKS IN CHILE

ROBERTO IGNACIO CARRILLO A.\*

## Abstract

The purpose of this work is to present the challenges to the regulation of the banking activity, which can range from the different phases of a national economy to non-financial factors that cannot be controlled by the respective national legislation, and that affect the decision-making underlying the banking regulation. These challenges will be illustrated by presenting the legislative reactions in Chile to two specific economic junctures: (i) the Chilean debt crisis of 1982; and (ii) the world financial crisis of 2008, which ultimately led to the incorporation into Chilean banking regulation of the Basel III proposals. In this context, this paper will focus in the new banking regulator, the Financial Market Commission, and the amendments to the General Banking Act.

**Key words:** *Banking Law, Financial Market Commission, financial crisis, Basel III, capital requirements, systematically important banks.*

## I. INTRODUCTION AND OVERVIEW

All over the world, banks and other financial institutions engage in activities that become more intricate by the day, complicating the oversight and enforcement duties of the relevant regulatory agencies. These entities must perform their duties within their respective jurisdiction, promote an efficient regulatory framework as well as establishing mechanisms to prevent future systemic risks.<sup>1</sup>

The financial crisis of 2008 is an example of how unprepared worldwide financial regulation was to prevent the failure of the banking system. This was partly due to the level of complexity of the transactions that the financial markets process every day that enables an environment where significant and different risks go undetected. These “systemic risks” were simply not the main concern of the

---

\* LL.M. in Corporation Law, New York University, J.D., Universidad de Chile, rcarrillo@ug.uchile.cl. Article received on November 29, 2019, and accepted for publication on January 7, 2020.

<sup>1</sup> In Chile, these principles are included in the provisions of the Act that created the Financials Market Commission (article 1, subparagraph 2 of the Law No. 21,000) and the Central Bank of Chile (article 3 of the Law No. 18,840).

regulatory frameworks at that moment which affected the entire system. On the other hand, because banks are engaging more often in activities outside of the traditional scope of the so-called “core banking activities”, while non-banking financial institutions are becoming involved in traditional banking operations, the functional regulatory distinction between these entities is becoming less clearer, if not almost nonexistent.

Because of this increasingly complex scenario, international organizations and governments have developed standards and regulations pervasive to the financial activity. On the international level, the main current standard is Basel III International Framework for Liquidity Risk Measurement Standards and Monitoring (“**Basel III**”), which “is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks.”<sup>2</sup> At a national level, countries have enacted laws specifically regulating the financial activity, incorporating governmental bodies or agencies or increasing their powers to enforce the new regulations.

The goal of this paper is to address the challenges that lawmakers typically face when regulating the banking activity, focusing on how related the lawmaking activity and the cyclical nature of the economy are, and how certain non-financial factors may trigger a legislative reaction. This reaction shall be illustrated by the fluctuations and periodical amendments to the Chilean Banking regulation as a result of two specific economic junctures, the Chilean crisis of 1982 and the financial crisis of 2008.

Since the causes of the financial crisis 2008 are well known and there is abundant literature on their regard,<sup>3</sup> this work will explain why the banking regulation in Chile had to be amended after the Chilean crisis of 1982 and the financial crisis of 2008. Because it is interesting for practitioners and lawmakers, this work will focus on a separate section on the Chilean banking regulation after the enactment of the Law No. 21,130 (“New Banking Regulation”),<sup>4</sup> which adopted the proposals of Basel III and addressed some local concerns, after the financial crisis of 2008.

## II. THE COMPLEXITIES OF REGULATING THE BANKING ACTIVITY

### 2.1 General background

This section address why countries must revisit their banking regulation from time to time and how certain circumstances outside of the legal scope compels this legislative exercise.

---

2 Bank for International Settlements, <https://www.bis.org/bcbs/basel3.htm> (last visited Nov. 24, 2019).

3 For an accessible discussion about the causes of the financial crisis of 2008, see RAMSKOGLER (2014).

4 This concept is preferred instead of “New General Banking Act” or “General Banking Act” because Law N°. 21,130 did not only amend the General Banking Act but also other special laws, including tax and mutual funds regulations.

Besides the inherent complexities of law making, the banking activity has certain features that make it especially challenging to regulate. Among others, it is possible to mention: (i) the cyclical nature of the economy; and (ii) certain non-financial factors which escape the influence of a national regulation.

## 2.2 The cyclical nature of the economy

Over time, the economy of a country may face either an expansion or a contraction phase and the latter can evolve into a recession. The goal of a legislative body when regulating the financial activity is, in part, to extend the recovery and prosperity phases of the economy, shortening the contractions and, ultimately, preparing it for a future recession. To this respect, Bloomberg highlighted that through regulatory (tax cuts) and non-regulatory factors (i.e., business and consumer confidence), the United States of America (“U.S.”) achieved 110 months of cyclical expansion, the longest on record.<sup>5</sup>

Also, the demands of key financial players and the reaction of the authorities on a recession phase vary from those of a prosperity phase. During an expansive economic phase, key players will demand more freedom to engage in riskier activities, while during a contraction phase the legislative and executive power impose restrictions and a hardened scrutiny over the financial operations that lead to a crisis. Ultimately, in a financial crisis the legislative and executive power may end-up funding the financial institutions that are near insolvency. During these crises, usually the so-called “lender of last resort” will be the one who provides funds to the financial institutions. For example, in the US the lender of last resort is the Federal Reserve Board,<sup>6</sup> while in Europe the European Stability Mechanism undertakes this role.

Therefore, the banking regulation must be dynamic, not static. It must change and adapt depending on the financial situation of the specific country, eventually having to step-up and intervene in the financial activity, sometimes against the agenda that the legislative power may originally had.

## 2.3 Non-financial factors

Despite the efforts of legislators, there are some circumstances outside of the financial scope that affects the economy and demands a reaction from lawmakers. Among others, the regulation of the banking activity has to consider the globalization of the economy, the social and political status of the country as well as a lack of risk-aversion of certain key players of the economy.

This attitude of the key players makes them to engage in riskier activities despite the restrictions imposed by the financial regulation, which can trigger a crisis on a national economy or a domino effect in other economies.

---

5 KEMP (2018).

6 For a discussion about the Federal Reserve Bank and its role as a lender of last resort see SPARKS (2017).

Two phenomena shall be presented to illustrate this point, the Chilean crisis of 1982 and the financial crisis of 2008. The first show how the above-mentioned factors can unpredictably impact a successful economy; while the second illustrate that, despite the fact that the operation and solvency of the Chilean banks were not impacted by the crisis, the legislative power decided to amend the bank regulation in order to adopt Basel III and address certain local concerns.

Since the financial crisis of 2008 caused the New Banking Regulation and consequently these amendments are more interesting to lawmakers and practitioners, they shall be addressed in detail in a separate section, while this section will cover briefly the causes and consequences of the Chilean crisis of 1982.

#### 2.4 The Chilean crisis of 1982

At the beginning of the 1980s, economists thought that the Chilean economy was invulnerable to the general debacle of the region and that it was an outstanding example of free market model.<sup>7</sup> After the arrival of Pinochet to power as a result of the military coup of 1973, free-market policies were implemented by a group of economists – the so-called “Chicago Boys”.

According to Michael Margitich, the implementation of this set of policies raised Chile to a leading position in Latin America.

Most late 1970s advocates of free-market economics believed that the long-term changes in economic philosophy [in Chile] brought upon Chile after the 1973 coup did indeed set Chile apart from the rest of the Continent (...) These policies had the underlying goals of increasing the flexibility of Chile’s economy and its ability to adapt well to external shocks.<sup>8</sup>

Among others, these rules included amendments to the banking regulation with the purpose of addressing local concerns, particularly with respect to bank loans.

There were severe problems in terms of rating self-granted loans (i.e., loans to related firms). In 1980, a more transparent and efficient credit system began to be implemented. As a first step, loans were rated in four categories (A, B, C and D). In August 1981, the Superintendence [of Banks and Financial Institutions] was vested with more power to control banks through an amendment to the law that was intended to bring an end to self-granted lending (...) It also required banks to classify the loans (consumer loans, mortgage loans, etc.).<sup>9</sup>

Now, even though Chile enacted public policies and had a booming economy, it suffered a tremendous financial crisis that forced the Government to step-up and revisit the banking law.

7 For a discussion about the success of the free-market model implemented in Chile during the 1970s and 1980s, see FONTAINE (2013).

8 MARGITICH (1999), p. 35.

9 FUENTES & MAQUEIRA (2000), p. 11.

In 1982, Chile suffered a debt crisis considered by most as the biggest financial crisis of its history, which ended up with more than \$18 billion of foreign debt. “After enjoying annual growth rates of around 8 percent between 1977 and 1981 ... Chile’s GDP [Gross Domestic Product] plunged by over 14 percent in 1982 ... Company after company collapsed under a mountain of bad debt, and Chile’s banks had become almost completely insolvent”.<sup>10</sup>

Although it is possible to mention many factors<sup>11</sup>, banks did play a major role in this financial crisis. Banks saw in the free-market policies implemented by the Chicago Boys an opportunity to engage in practices that contributed significantly to the crisis.

One of the policies adopted by the Chicago Boys was to privatize Chile’s banking system. In order to implement this, credit controls were derogated, restrictions on related party transactions were lessened and controls over interest rate ceilings were amended. These controls were originally set to direct capital into production, instead of consumption, but consequently produced a loss of control over the loans market due to the lack of financial education of the population. “Debtors (...) seem[ed] oblivious to the losses they were suffering due to the high interest rates on their borrowed money (...) [B]anks were willing short-term lenders, and these debtors found that the alternative to facing up to their debt was to borrow more”.<sup>12</sup>

Banks did not only abuse from their discretion to grant loans to clients, but they also started to finance their shareholders and related parties, without any guarantee supporting these loans. In the end, these practices, that became common among banks, caused a collapse of the banking system.

The existence of an implicit insurance to deposits created the well-known moral hazard problem in bank lending and the absence of prudential supervision allowed banks to intermediate funds toward related companies. Economic groups owned banks and related companies that went bankrupt when external financial resources became scarce. These economic groups were especially affected by the devaluation of the peso during the second semester of 1982, with the exception of export-oriented groups and with a low leverage in dollars.<sup>13</sup>

As a reaction of the financial consequences of the practices of banks of that time, the decision was made to bail out those banks who were on default through the purchase of their delinquent loans,<sup>14</sup> and to amend the banking regulation.

---

10 MARGITICH (1999), p. 37.

11 Citizens made poor financial decisions because of a lack of financial education and scarce information that the financial institutions provided to them, factors that made them surpass rational levels of indebtedness.

12 Margitich, *supra* note 7, at 40.

13 FUENTES & MAQUIEIRA (2000), p. 10.

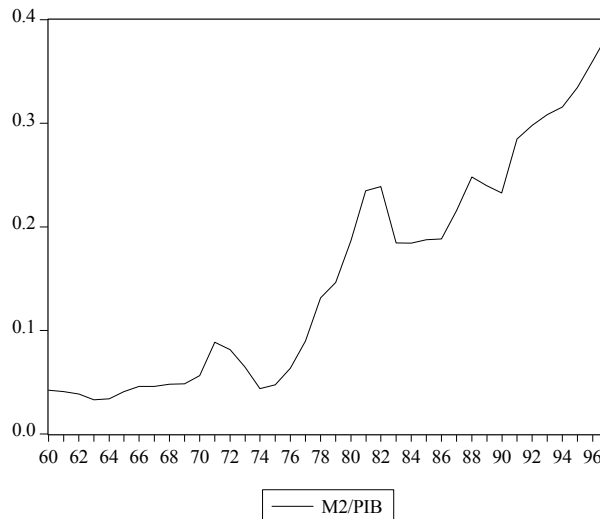
14 This proved not to be enough to save banks, triggering the so-called re-privatization of banks in the mid-1980s.

In 1982, a major amendment to the Bankruptcy Law was enacted, in order to deal with companies that became or were going to become insolvent due to the financial crisis. Later, in 1986 Congress enacted an amendment to the banking regulation, which was revisited again in the 1990s. Among others, the focus of these amendments was to impose higher transparency standards, deter certain damaging business practices engaged by banks, especially with respect to lending, which were deemed as the cause of the crisis. Also, restrictions were also imposed on banks when they engaged in related party transactions. The goals of these amendments are clearly explained by Fuentes and Maquieira.

This new banking law included two important changes to protect creditor's interests. First, a bank cannot lend money under better conditions (period of grace, interest rate and guarantees), compared to other individuals and firms, to parties that have any direct or indirect relationship with the owners or with officials of the bank (insider trading). Second, the bank is not allowed to grant a loan either directly or indirectly to any member of the board of directors or any representative of the bank.<sup>15</sup>

This new regulation allowed the financial market to reengage the prosperous trend that the Chilean economy had before the 1982 debt crisis. The following illustration was prepared by the Central Bank of Chile to show how the GDP varied from the liberalization of the economy until the end of the 1990s. The graphic evidence the initial effect of the policies implemented by the Chicago Boys, the debacle of the economy due to the 1982 debt crisis and its solid recovery.

Evolution of M2/PIB, 1960-1997



Source: Central Bank of Chile

15 FUENTES & MAQUIEIRA (2000), p. 12.

As a result of these policies, Chile's economy recovered and boomed during the last decades, and it has been recognized as one of the leading countries in the region, with strong institutions and a liberalized market. To illustrate this point, on April 30, 2019, Banco de Chile paid its subordinated debt acquired on 1982 with the Central Bank, the last vestige of the Chilean crisis of 1982.

### III. THE NEW BANKING REGULATION

#### 3.1 The regulation of the banking activity prior to the amendment of the GBA

Before explaining the factors that triggered the amendments of the banking regulation after the financial crisis of 2008, it will be briefly introduced the authorities and the laws applicable to banks in Chile.

Prior to the enactment of the New Banking Regulation, the main regulators of banks were the Superintendence of Banks and Financial Institutions (*Superintendencia de Bancos e Instituciones Financieras*, the "SBIF") and the Central Bank of Chile (*Banco Central de Chile*, "BCCH").

The SBIF was created in 1925, based on the Banking Regulator of New York of that time and its regulation can be found in the First Title of Decree with Force of Law No. 3 of 1997 (this Decree and its subsequent amendments are known interchangeably as the "General Banking Act" or the "GBA"). The purpose of the SBIF was to issue regulation, to supervise and oversee the activity of banks and financial institutions and sanction those entities who breached said rules. In short, the SBIF's legal mandate was to monitor the referred entities in order to safeguard the owners (depositors) of bank accounts and the public interest, and consequently to preserve the stability of the financial system. This institution was run by a directive body lead by a Superintendent, appointed by the President of the Republic of Chile. The SBIF included two Intendents, a Supervision Intendent and a Regulation Intendent.

To illustrate its role as the main regulator of banks, SBIF's prior authorization was necessary to incorporate a bank, or an international branch or a representative office, including the amendment of a bank's articles of incorporation. This approval was necessary to transfer any ownership interest over 10% of a bank's equity and for any major corporate reorganization such as a merger or the termination of a bank (the so-called "fit-and- properness test").

The BCCH was created in 1925 and is now established on the Organic Constitutional Law No. 18,840 issued in 1989 ("BCCH Act"). The BCCH was designed as an autonomous and technical entity. Under article 3 of the BCCH Act, its purpose is to monitor the stability of the currency and the normal flow of internal and external payments. To carry out its purpose, the BCCH is enabled to regulate the amount of money and credit supply, the execution of credit and international trade operations and the issuance of monetary, exchange, credit and international trade regulation. The BCCH is run by a Counsel composed of five members, one of which acts as its President.



Other regulators and authorities that currently have a relevant role in regulating the activity of banks are the National Consumer Service (*Servicio Nacional del Consumidor*, the “SERNAC”); the Financial Market Commission (*Comisión para el Mercado Financiero*, the “CMF” or the “Commission”); and the Financial Analysis Unit (*Unidad de Análisis Financiero*, the “UAF”).<sup>16</sup>

With respect to the legal framework of banks in Chile, in their paper “Banking regulation in Chile: overview”, Felipe Moro and Diego Lasagna describe the most important laws and regulations that govern Chilean banks. They include the General Banking Act, the SBIF’s Updated Compilation of Rules; the Compendium of Financial Regulations issued by the BCCH (“Compendium”); Law No. 18,046 (“Corporations Act”); Law No. 18,010 (“Money Lending Operations Act”); Law No. 18,045 (“Securities Market Act”) and the Law No. 20,393, that governs the liability of legal entities due to the commission of certain qualified crimes, such as financing of terrorism and money laundering. We could moreover add Law No. 19,496 (“Consumer Protection Act”).

From all these laws, the GBA is the most important regulation for banks. As stated by Moro and Lasagna, “[t]he General Banking Act, amended most recently in 2015, has expanded banks’ traditional business. This has allowed them to engage in new activities, such as underwriting new issues of certain debt securities and creating subsidiaries for new related areas such as brokerage, equity underwriting, investment advisement, mutual fund services, administration of investment funds, factoring, securitization and financial leasing services.”<sup>17</sup>

SBIF’s Updated Compilation of Rules is composed of different general application regulation, that is issued from time to time, organized in chapters (currently, 20 chapters). It covers a variety of topics, which range from the banking hourly schedule to be open to the public to the issuance of subordinated bonds. These rules are a clear example of the rule-making power of the former SBIF, now CMF, and enables banking regulation to be updated without the need for a legal reform.<sup>18</sup>

---

16 The SERNAC is tasked with the enforcement of the consumer laws, which include the rights of consumers when they enter into financial service agreements. On the other hand, after the enactment of the New Banking Regulation, the CMF recently absorbed the SBIF, thereby becoming the main regulator of both the securities and insurance markets as well as of banks. Finally, in 2003, the UAF was incorporated by the enactment of the Law No. 19,913, to avoid certain practices of both key players of the economy and of entities that manage funds on behalf of third parties, such as AML/CFT. Among other entities, banks must report any suspicious activity to the UAF, comply with periodical reporting obligations and establish a compliance officer, as a liaison between the relevant bank and the Chilean Financial Intelligence Unit.

17 For a review of this document, see MORO & LASAGNA (2019).

18 With respect to the application of the Corporation Act to banks, under article 40 of the GBA, a bank is defined as a special corporation. Consequently, article 41 of this Act provides that banks shall be governed by the GBA and, in its silence, by the Corporations Act. Also, article 43 of the GBA provides that a bank’s by-laws must comply with the general requirements for any corporation established by the Corporations Act and the special requirements established for those corporations incorporated as banking entities. However, the Corporation Act does not apply to banks with respect



### 3.2 The New Banking Regulation: Basel III and its adoption in Chile through the amendment of the GBA

Paul Ramskogler summarized the causes of the financial crisis of 2008, explanation that bring to remembrance the non-financial factors that we already discussed, specifically the globalization of the economy and the socio-political situation of the countries.

[B]efore the crisis, a unique combination of fundamental innovations and geopolitical developments had led to a decline in inflation and thus policy rates. At the same time, export-focused policies in Asia shifted substantial amounts of capital into the market for US treasuries, thereby pushing down long-term interest rates in the United States as well. These factors made loans cheap. On the demand side, people apparently tried to offset a loss in relative income, which led to significant growth in mortgages. At the same time, the rise of institutional investors created a ready base of potential buyers of securitised bonds. As securitised bonds were regarded as a substitute of insured deposits (a view that turned out to be wrong), institutional investors' mortgage market-related holdings surged before the crisis. As soon as trust in the underlying assets started to erode, the fragile structure imploded. As a matter of fact, the creation of deposit equivalents outside the realm of deposit insurance and the lack of a lender of last resort led to a new version of a classic 19th century bank run.<sup>19</sup>

The international scenario after the financial crisis of 2008 was like the one described for in the Chilean crisis. In order to avoid the filing of bankruptcy proceedings, the US government rescued several banks. However, the crisis crossed the borders of the US; it affected almost every open-market country of the world. To address this problem, new standards for the banking activity were introduced to avoid a future crisis. The Financial Stability Board and the G-20 gathered, and their efforts culminated in 2010 with the release of a set of proposals contained in Basel III.

---

to the following matters: requirements to obtain the prior approval of the shareholders' meeting to grant a security or a bond, either simply or jointly liable; withdrawal rights of shareholders; and to consolidation of the balance sheets. The Money Lending Operations Act provides a definition for money lending operation. Also, it includes mechanisms to calculate interests and the interest rate ceiling (*interés máximo convencional*). In this regard, this law defines a credit operation as transactions whereby one of the parties commits to deliver an amount of money at a different time as that when the other party commits to make a payment. About the application of the securities regulation to banks, since banks engage in financial activities (*e.g.*, when a bank act as an underwriter), they interact with securities and consequently are subject to the Securities Market Act. The Consumer Protection Act sets forth the legal framework for consumers in their relationship with the providers of services. Since its enactment, it has been amended in several opportunities, among them, establishing rights of consumers in financial services and granting broader powers to the SERNAC. Considering that this Act contain one of the few exceptions that allows a plaintiff to file a class action in Chile, it is material for banks to consider it.

19 RAMSKOGLER (2014).

According to the Bank for International Settlements, Basel III's purpose is to strengthen the following components of the banking regulatory framework:

- improving the quality of bank regulatory capital by placing a greater focus on going-concern loss-absorbing capital in the form of Common Equity Tier 1 (CET1) capital;
- increasing the level of capital requirements to ensure that banks are sufficiently resilient to withstand losses in times of stress;
- enhancing risk capture by revising areas of the risk-weighted capital framework that proved to be acutely miscalibrated, including the global standards for market risk, counterparty credit risk and securitisation;
- adding macroprudential elements to the regulatory framework, by:
  - (i) introducing capital buffers that are built up in good times and can be drawn down in times of stress to limit procyclicality; (ii) establishing a large exposures regime that mitigates systemic risks arising from inter-linkages across financial institutions and concentrated exposures; and
  - (iii) putting in place a capital buffer to address the externalities created by systemically important banks; and specifying a minimum leverage ratio requirement to constrain excess leverage in the banking system and complement the risk-weighted capital requirements.<sup>20</sup>

In short, the goals of Basel III are to increase the level and quality of the bank's capital and to adopt other measures to prevent a systematic failure of the banking system.

On March 2018, the SBIF released a short memo addressing the law that Congress was discussing to implement Basel III in Chile. In the document, the SBIF explained why it was important to adopt these international standards,<sup>21</sup> indicating that their incorporation provided a common measure to quantify risks and to define the necessary resources to implement them. Specifically, Basel III addressed many problems of the workings of the banking systems that were the unintended result of by Basel II, among others, resources of supervision were transferred to approval and validation to internal models. This decision, in addition to many years of low global interest rates and the proliferation of instruments and vehicles, transferred the exposure out of the bank's balance. This, in turn, strengthened the leverage in the international banking system, leading to the financial crisis of 2008.

In addition to the concerns connected to Basel III, in Chile there was a consensus that neither the Superintendencia of Securities and Insurance (*Superintendencia de*

20 Bank for International Settlements, <https://www.bis.org/publ/bcbs189.htm> (last visited Nov. 25, 2019).

21 Superintendencia de Bancos e Instituciones Financieras, *Implementación de Basilea III en Chile: Fundamentos y Desafíos* (Serie de Estudios Normativos, 18/01, 2008).

*Valores y Seguros* or “SVS”), now CMF, nor the SBIF had the powers to effectively exercise oversight over the economic conglomerates operating in the country. In this regard, years ago, the Organization for Economic Co-operation and Development recommended Chile to have only one regulator for the financial activity, which would be in charge of overseeing this activity with broader powers, because this was more effective than Chile regulatory landscape at the time. The recommendation was implemented through the merger between the SBIF into the CMF, which was part of the amendment to the banking regulation.

As in the Chilean crisis of 1982, several of the mentioned non-financial factors were involved in the decision to adopt the proposal of Basel III and amend the banking regulation. On the one hand, the adoption of international standards was a consequence of the globalization of the economy and the financial systems and a political decision of Chile to become a more relevant player in the international field. On the other hand, the concerns about the SBIF’s effectiveness were due to the abuses of the economic conglomerates that have been operating in Chile for the last decades, which were reflected in their involvement in several cartel and antitrust cases which shocked the public opinion.

### 3.3 The new banking regulator, the CMF

On January 12, 2019, Law No. 21,130, for the Modernization of the Banking Regulation was enacted. This law amended the General Banking Act to address the concerns of Basel III and included other relevant novelties in the Chilean banking regulation, such as the mentioned merger of regulatory bodies into the CMF.

Prior to the enactment of the New Banking Regulation, the sector regulator was the SBIF. Now, according to article 2 of the GBA, the oversight of all banking entities in Chile, including the State-owned commercial bank of Chile (*Banco del Estado de Chile*) corresponds to the CMF.

To empower the newly appointed banking regulator, the New Banking Regulation adopted the following decisions:

- I. Law No. 21,000 that incorporated the CMF was amended, to provide the Commission with powers akin to the new banking regulator. For this, the first subparagraph of article 67 was amended and now includes a sentence in which it is stated that the CMF is the successor of the SVS and of the SBIF.<sup>22</sup>
- II. All the sanctions set forth in the GBA were either suppressed or complemented by those already established in the law governing the CMF.<sup>23</sup>

22 Consistent with this transference of powers, other provisions of the Law No. 21,000 were amended. For example, article 3 now states that the Commission shall oversee banks and the rest of the financial entities formerly monitored by the SBIF (article 3 No. 8 and 9 of the Law No 21,000). Also, article 36 of this law was amended, to include banks among the entities that could be sanctioned by the CMF (subparagraph 1 article 36 of the Law No. 21,000).

23 According to article 19 of the GBA: “The corporations, natural persons or entities subject to the oversight of the Commission, by virtue of this law, that incur in an infraction of the laws, regulations,

III. The GBA was amended to indicate that the authorizations that, by law, were to be issued by the SBIF would now be granted, when applicable, by the CMF.<sup>24</sup>

Before explaining its powers, we will briefly introduce the CMF. As mentioned, it was created by Law No. 21,000, which was enacted on February 23, 2017, replacing the former regulator of securities and insurances, the SVS. The CMF is a collegial entity, led by a Council composed of five members, one of which acts as its President. The CMF internal structure is composed of an Investigation Unit, led by a chief Prosecutor and different Intendencies (*Intendencias*) per each of the areas of the financial activity that it oversees (i.e., Intendency of Regulation of Securities, Intendency of Insurances, among others).

Since there was this notion that the SVS and the SBIF did not have the powers nor the structure to oversee efficiently the financial scenario in Chile, Law No. 21,000 granted the CMF broader powers than those of the SVS, contemplating from the beginning that it was eventually going to absorb the SBIF in the near future, which happened on June, 2019.

To this respect, it should be noted that the SVS was entitled to impose fines through an administrative procedure and to refer the case to the Public Prosecutor (*Ministerio Público*) when criminal liability rose from a breach to sector regulation. Now, the CMF has an Investigation Unit, led by special prosecutors, which aims at improving the enforcement of financial laws and implementing a modern administrative prosecution system. In qualified and serious circumstances, these prosecutors can instruct intrusive measures (e.g., intercept communications) and request the disclosure of information and operations subject to banking secrecy or reserve,<sup>25</sup> only when it is considered indispensable for verifying an infraction typified as a criminal offence. Moreover, the law that incorporated the CMF includes a leniency system, to promote self-denouncement and a simplified procedure for breaches of lesser importance.<sup>26</sup>

---

statutes and other rules governing them or infringe the instructions or orders legally provided by the Commission, may be sanctioned according to the rules set forth in the Title III of the Law No. 21,000 [which incorporated the Commission] ... notwithstanding the special sanctions included in this or other legal bodies.”

24 For example, if a bank became insolvent, the prior approval of the SBIF was required to pay the deposit insurance to the deposit-taker. This payment of the insurance requires in turn the prior issuance of a resolution by the CMF upon the declaration of liquidation of the relevant bank. It is worth mentioning that the amount of the deposit insurance is capped to 200 *Unidades de Fomento*, but it can be increased up to a total of 400 *Unidades de Fomento* if the relevant person has products in more than one bank than become insolvent.

25 To be consistent with the power to disclose the information subject to bank secrecy, Law No. 21,130 amended article 82 of the GBA, which regulates the monitoring powers of the CMF over banks and their branches incorporated abroad by Chilean banks. Formerly, the second subparagraph of this article considered the information subject to bank secrecy as a restriction to the monitoring powers of the SBIF. After the amendment to the GBA, the second subparagraph of article 82 provides that: “With respect to the information protected by the bank secrecy, it shall proceed according to article 5 No. 5 [which provides the cases where a prosecutor can request the disclosure of the information subject to bank secrecy] of the Law 21,000 that incorporates the Financial Market Commission”.

26 For more information about the CMF, please visit its website: [www.cmfchile.cl](http://www.cmfchile.cl).

Since the CMF absorbed the SBIF on June 2019, it is still too soon to draw comparisons between the previous system and the new. However, there are reasons to think that the CMF's approach on how to enforce the banking law will be different from the SBIF's. Normally, a banking regulator focuses on solvency (i.e. prudential approach), while a securities regulator centers its attention on the activities of the players of the financial activity (so-called "market conduct"), which is a more business-oriented approach.

Since an interdisciplinary commission will guide the enforcement of the banking law, I believe the approach to the enforcement of the banking regulation is likely to be more holistic, considering the financial system as a whole and focusing on the unfoldment of the financial activity. This will also allow address the concern of the lack of risk-aversion of the sophisticated financial institutions and conglomerates that are operating in Chile, given that the CMF now has a specialized Investigation Unit, focused in infractions to the financial regulation.

### **3.4 New capital requirements for banking entities**

To understand the capital requirements for banks after the enactment of the New Banking Regulation, we will begin by analyzing article 66 of the GBA.

Previously, this article stated that: "The net worth of a bank cannot be less than 8% of its risk-weighted assets, net of the required provisions. The basic capital cannot be less than 3% of the aggregate assets of the bank, net of the required provisions". Now, article 66 of the GBA requires banks with a basic capital, which cannot be less than 4.5% of its risk-weighted assets, or 3% of the aggregate assets of the bank.

Moreover, to comply with the capital minimums, article 66 of the GBA included a list of factors that could compose the net worth of the bank. Among others, this rule included the bank's paid capital and reserves or basic capital, subordinated bonds placed by the bank, and voluntary provisions. This regulation includes preferred stocks and perpetual bonds placed by the bank, tools which were incorporated by Law No. 21,130 that allow banks to raise capital.<sup>27</sup>

Also, Congress included several provisions after article 66, straightening capital requirements for banks, in line with Basel III.

First, under article 66 bis banks are required to keep an additional basic capital equivalent to 2.5% of their risk-weighted assets, net of the required provisions, over the basic capital required under article 66 of the GBA.

Second, by virtue of article 66 ter of the GBA, the BCCH now has the power to activate a counter-cyclical additional basic capital, in consideration of the phase of the economic cycle. The counter-cyclical additional basic capital can range from

---

<sup>27</sup> Article 55 bis of the GBA has the regulation of the powers of banks to issue preferred stocks and perpetual bonds.

0% to 2.5% of the risk-weighted assets of the banks, net of the required provisions. A resolution of the Counsel of the BCCH shall determine the counter-cyclical additional basic capital to be required from each bank and the term to comply with it, which cannot be less than 6 months since its imposition.<sup>28</sup>

Third, article 66 quarter of the GBA provides that the CMF can determine whether a bank or groups of banks have “systemic importance” (*importancia sistémica*). The CMF will have to issue a regulation of general application (*Norma de Carácter General*) to establish the criteria and methodology to make this determination.<sup>29</sup> On August, 2019, the CMF issued a proposal of regulation on this matter, but it has not yet issued the regulation of general application. The final resolution of the CMF’s Counsel on this matter will require the prior approval of BCCH.

This determination is material for banks since a bank with systemic importance may be forced by the Commission to comply with additional requirements.<sup>30</sup>

In connection to the above, the New Banking Regulation empowered the CMF to determine the acceptable standardized methodologies to calculate the risk-weighted assets of the banks,<sup>31</sup> although the CMF’s requires prior approval of the BCCH’s Counsel.

Sanctions and new powers were granted to the CMF to ensure that banks comply with the new capital requirements. For example, if a bank does not comply with the additional basic capital set forth in articles 66 bis and 66 ter of the GBA, its right to distribute dividends will be limited, depending on the severity of the non-compliance. If the deficit is over 75% of the required level of additional basic capital, the relevant entity is prohibited from distributing dividends at all on that year.<sup>32</sup> Also, if the risks of a bank are not properly addressed by the capital requirements of the GBA, the Commission can impose additional economic requirements. However, these requirements cannot exceed in the aggregate 4% of the bank’s risk-weighted assets, net of the required provisions.<sup>33</sup>

---

28 The Commission is entitled to issue regulation to set forth the rules for the implementation and oversight of this required capital.

29 Despite this, the GBA provides some factors that may be included in this regulation, such as the size of the bank, the share of the bank in the market, the interconnection with other financial entities, among others.

30 Among others, the CMF may force a bank with systematic importance: (a) to increase between 1.0% to 3.5% the basic capital determined over the risk-weighted assets, net of the required provisions required by article 66, over the minimum 8% referred in said article; (b) to increase up to 2% the basic capital determined over the aggregate assets of the bank, net of the required provisions required by article 66, over the minimum 3% referred in said article; (c) to apply a different formula to calculate the bank legal reserve to the one provided in article 65 of the GBA; and (d) to reduce by 20% the margin of interbank loans allowed under article 84 No. 1 of the GBA.

31 Article 67 of the GBA.

32 Article 56 of the GBA.

33 Article 66 quinquies of the GBA.

By imposing these new capital requirements and recognizing the importance of certain banks, the New Banking Regulation is prioritizing the oversight conducted by the CMF on those players who are the most sophisticated in the market, and whose insolvency may create a domino-effect on the system as a whole.

### **3.5 Rules for controlling shareholders and corporate governance of a banking entity**

The New Banking Regulation did not only modernize the banking regulator and incorporated new capital requirements, it also established new rules for the controlling shareholders and the corporate governance of banks, in order to comply with international standards and address the externalities produced by a bank with systemic importance within the Chilean banking system.

Before the enactment of the New Banking Regulation, article 28 of the GBA provided specific requirements for the founders of a banking entity. Now, this article contemplates a fit-and- properness test for the controllers of a bank, empowering the CMF with the right to require them with a certain solvency level.<sup>34</sup>

Also, to comply with international standards, the GBA now establishes stricter requirements for those individuals who are appointed as directors of a bank. For this, a new article – 49 bis of the GBA – contemplates the set of incapacities for these people, such as being convicted of a felony (imprisonment for more than three years), being convicted for corruption or any other crime related to a public function in general, or being convicted of a tax offence or crimes contemplated in the Securities Market Act.

### **3.6 Banking resolution measures: ERP and improvement of mandatory liquidation for troubled entities**

Due to the dramatic scenario of the financial crisis of 2008, the General Banking Act was heavily amended to anticipate and mitigate the effects of a potential default of a bank and the domino effect that its default may cause on the system. Also, an ancillary goal of these amendments was to adjust the GBA to the Law No. 20,720 on Reorganization and Liquidation of Corporations and Individuals (“Bankruptcy Act”).<sup>35</sup>

---

34 If a controlling shareholder incurs in any of the infractions contemplated by numbers iv, v and vi of the letter d) of article 28 of the GBA, the Commission can make them dispose of the number of shares that they held up to an amount that makes them lose control over the banking entity. In short, these numbers include felonies, administrative sanctions and bankruptcy proceedings. Finally, if a bank does not comply with the additional capital requirements mentioned before, a prohibition to acquire more shares in that banking entity can be imposed on its controlling shareholders (article 66 bis of the GBA).

35 In short, the Bankruptcy Act included a new reorganization proceeding, which may lead to the liquidation of the corporation in case the reorganization plan fails.



First, Title XIV<sup>36</sup> was included in the GBA, providing for the obligation of banks to file an early regularization plan (“ERP”) in certain qualified cases, which is a new mechanism in the banking system to detect entities in the initial steps of financial distress.

Pursuant to Title XIV of the GBA, banks must immediately report to the CMF when certain events occur. Among others, article 112 provides that this reporting obligation is triggered when they default in any of their economic requirements, when they repeatedly fail to comply with the banking regulation in general or when they will not be able to comply with their payment obligations within thirty days.

Thanks to this obligation, the CMF, as the new banking authority, has additional information to discover and deal with banks that will be or currently are in financial distress. Since this information must be provided not upon the verification of a certain period (annually, semiannually, quarterly, etc.), but upon the verification of an event related to the solvency of a bank, the Commission can prevent a systematic effect on the whole banking system.

Upon the occurrence of an event listed in article 112 of the GBA, within the next five days, management of a bank must file an ERP before the CMF, which must include concrete measures to solve the situation that triggered the filing obligation and ensure the normal operation of the bank. Besides the CMF’s approval, unless otherwise provided by the Commission, the ERP must be completed in no more than six months from its adoption.<sup>37</sup>

The GBA provides for special rules if a plan’s condition is to increase the capital of a bank. If the increase is not approved by the bank’s shareholders’ meeting or if the shareholders don’t pay the approved capital increase, the plan shall be considered automatically failed and the Commission may proceed to impose one or more of the temporal prohibition set forth in article 116 of the GBA, appoint a delegated inspector or a provisional administrator, or initiate an action governed by the Bankruptcy Act.<sup>38</sup>

On the other hand, if the plan is not approved by the CMF or is not filed on time or the bank does not comply with the terms and conditions set forth in the resolution of the CMF approving the plan, either a delegated inspector or a provisional administrator must be appointed, and may suspend any board of directors’ or managers’ decision. Despite these appointments and unless the bank is declared liquidated, the bank will still be operating, but said operation will be overseen by the relevant appointee.<sup>39</sup>

Upon the appointment of a delegated inspector or provisional manager, any agreement executed or payment obligation incurred by the relevant bank will remain in effect, and this appointment may not be invoked as a cause to terminate early an

---

36 Articles 112 to 118 of the GBA.

37 Article 113 of the GBA.

38 Article 113 of the GBA.

39 Article 117 of the GBA.

agreement by a unilateral decision of the creditor or to accelerate the obligations of the agreement or to enforce a guarantee. The appointment of the delegated inspector or provisional manager will last no more than one year, unless it is renewed by the CMF for one more year, as many times as it deems necessary.<sup>40</sup>

Finally, upon the verification of any of the events established in article 112 of the GBA the CMF is entitled to establish provisional prohibitions to a bank. For a maximum period of 6 months, the Commission can prohibit a bank to grant loans to any person or legal entity related, directly or through third parties, to the ownership or management of the entity, renew any credit for more than one hundred and eighty days, acquire or sell certain assets, grant unsecured loans, among other measures. During these prohibitions, the removal or resignation of any member of the board of directors or key executives of the bank will require the CMF's prior approval.<sup>41</sup>

Further, Title XV<sup>42</sup> was included in the General Banking Act to regulate the mandatory liquidation of banks. Its goal was to adjust the language used in the banking regulation to the procedures now existing under the Bankruptcy Act<sup>43</sup> and to derogate certain mechanisms for insolvent banks that were inconsistent with the referred bankruptcy legal framework.<sup>44</sup>

In addition, an "insolvency" presumption was included among the provisions of Title XV. Under article 130, upon the verification of certain qualified cases it will be presumed that a bank does not have the necessary solvency to continue operating or that the safety of its deposit-takers and other creditors requires the bank's liquidation. The law provides for certain qualified cases and a general standard that expands the application of this rule. The former includes whenever a bank does not comply with the financial requirements set forth in the GBA or does not pay the loans granted by the BCCH, while the latter triggers the presumption when a bank has suspended its payment obligations, including those to any clearing house.<sup>45</sup>

Lastly, the New Banking Regulation updated the former special liquidation procedure for banks, according to modern procedural standards. For example, the GBA provides that the notices that the liquidator must send to the creditors can be sent by e-mail, if available.<sup>46</sup>

---

40 Article 117 of the GBA.

41 Article 116 of the GBA.

42 Articles 120 to 153 of the GBA.

43 For example, article 120 of the GBA was amended in order to expressly state that banks can be subject to a reorganization or liquidation procedure under the Bankruptcy Act or to any of the special provisions for banks set forth in the new Title XV of the GBA.

44 In this regard, articles 122 and 129 of the GBA were derogated, which contemplated the regulation of the creditors' agreements in an insolvency proceeding.

45 Article 130 letter e) of the GBA.

46 Article 133 of the GBA.

#### IV. CONCLUSION

Regulating the banking activity is an exercise that must consider certain special challenges. Due to the nature of the economy, and certain non-financial factors, ranging from the globalization of the economy to the lack of risk-aversion of the sophisticated players of the banking activity, lawmakers must revisit the banking regulation from time to time and adapt it to these factors. Chile is not the exception to this rule. After its crisis in 1982 and the global financial crisis of 2008, the Chilean banking regulation incorporated the proposals of Basel III and addressed certain more local concerns, with the goal of properly addressing the challenges of modern financial activity.

After reviewing the New Banking Regulation, it is possible to conclude that the CMF, as the new banking regulator, has more powers than its predecessor (the SBIF) to oversee banks and their operations. Also, thanks to the enactment of the Law No. 21,130, the CMF is reasonably empowered to detect promptly any abnormality in the operation of a bank, particularly through the obligation to report certain events that can trigger the obligation to file an ERP and the corresponding mechanisms to prevent a systematic failure of the financial system. In consequence, it can be inferred that Chile properly addressed most of the concerns analyzed that triggered the need to amend the banking regulation, including the factors that we have discussed in detail. Particularly, the Chilean banking system seems reasonably compliant with the expectations set forth by Basel III and the international community.

Despite all, as it was illustrated by the amendments introduced to the Chilean banking regulation after the financial crises previously analyzed, it is likely that the lawmakers in Chile will have to revisit in the future the banking regulation, regardless of the efforts and preventions considered when issuing the New Banking Regulation.

## BIBLIOGRAPHY CITED

- CORRIGAN, Gerald (2012). *Reporte anual 1982, Are Banks Special?*, Reserva Federal de Minneapolis, [http://www.bu.edu/econ/files/2012/01/Corrigan-Are-Banks-Special\\_main-text.pdf](http://www.bu.edu/econ/files/2012/01/Corrigan-Are-Banks-Special_main-text.pdf) [last visit November 24, 2019].
- DE GREGORIO, JOSÉ (2004). *ECONOMIC GROWTH IN CHILE: EVIDENCE, SOURCES AND PROSPECTS* (Working Papers Central Bank of Chile 298, Banco Central de Chile).
- FONTAINE, Juan Andrés (2013). “Transición Económica y Política en Chile: 1970-1990”, *Estudios Públicos* No. 5, pp. 229-279.
- FUENTES, Rodrigo & MAQUIEIRA, Carlos (2000). “Institutional arrangements, credit market development and loan repayment in Chile”, Working Paper, *Facultad de Economía y Negocios, Universidad de Chile*.
- KEMP, John (2018). “Commentary: U.S. economy accelerates towards cyclical peak”, <https://www.reuters.com/article/uk-usa-economy-kemp/commentary-u-s-economy-accelerates-towards-cyclical-peak-idUKKCN1LG12S> [last visit November 25, 2019].
- MARGITICH, Michael (1999). *The 1982 Debt Crisis and Recovery in Chile* (Lehigh University, Lehigh Preserve).
- MORO, Felipe & LASAGNA, Diego (2019). “Banking Regulation in Chile: Overview”, at: [https://uk.practicallaw.thomsonreuters.com/w-007-9128?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/w-007-9128?transitionType=Default&contextData=(sc.Default)&firstPage=true) [last visit November 25, 2019].
- RAMSKOGLER, Paul (2014). “Tracing the Origins of the financial crisis”, *OECD Journal, Market Trends*, Vol. 2014/2, pp. 47-61.
- SPARKS, Karol K. (2017). *The Keys to Banking Law A Handbook for Lawyers* (American Bar Association, Business Law Section, 2nd ed.).

---

## LEGISLATION CITED

**Chile:**

- Decreto con Fuerza de Ley N°3 de 1997 (Ley General de Bancos), published on December 19, 1997.
- Ley N° 18.010 (Ley de Operaciones de Crédito de Dinero), published on June 28, 1981.
- Ley N° 18.045 (Ley de Mercado de Valores), published on October 22, 1981.
- Ley N° 18.046 (Ley de Sociedades Anónimas), published on October 22, 1981.
- Ley N° 18.840 (Ley Orgánica Constitucional del Banco Central de Chile), published on October 10, 1989.
- Ley N° 19.496 (Ley de Protección al Consumidor), published on March 7, 1987.
- Ley N° 19.913 (Ley que crea la Unidad de Análisis Financiero), published on December 18, 2003.
- Ley N° 20.393 (Responsabilidad Penal de las Personas Jurídicas), published on December 2, 2009.
- Ley N°. 20.720 (Reorganización y Liquidación de Empresas y Personas), published on January 9, 2014.
- Ley N° 21.000 (Ley que crea la Comisión para el Mercado Financiero), published on February 23, 2017.
- Ley N° 21.130 (Modernización de la Regulación Bancaria), published on January 12, 2019.