Pillar II of Basel III standards

CMF publishes for consultation a new version of regulatory amendments on capital requirements for banks

The proposal introduces enhancements to facilitate the supervisory process and improve some aspects of capital regulation and risk determination. This comes after three assessment cycles for sufficiency of effective capital in the banking sector.

October 11, 2024 – The Financial Market Commission (CMF) published for consultation today a new version of amendments to the regulation determining additional capital requirements because of the supervisory process, known as Pillar 2 of the Basel III standards.

An initial version of these amendments was published for consultation between December 12, 2023 and March 15, 2024. The new version under consultation gathers and covers the main concerns raised regarding said initial version. The proposal enhances Chapter 21-13 of the Updated Compilation of Rules for Banks (RAN), issued in 2020, to facilitate the supervisory process and improve some aspects of capital regulation and risk determination.

In 2019, the CMF began implementing Basel III standards in Chile following the publication of Law No. 21,130, which modernizes banking legislation. Specifically, Article 66 Quinquies of the General Banking Act (LGB) enabled the Commission to set forth through a General Rule the criteria and guidelines to consider when determining additional capital requirements (Pillar 2) because of the supervisory process. This occurs when the CMF recognizes that banking entities present risks insufficiently covered by Pillar 1 requirements, which include the traditional credit, market, and operational risks.

Depending on their business model, banks may be exposed to non-traditional risks such as banking book market; credit concentration; reputation; strategic; cybersecurity; geopolitical; and climate risks, among others.

Pillar 2 requirements are determined on a case-by-case basis through a founded resolution and the favorable vote of at least four of the five members of the Commission's Board. They may not exceed 4 percent of the bank's net risk-weighted assets (i.e., after discounting the required provisions).

Following the issuance of Chapter 21-13 of the RAN in September 2020, which establishes the criteria and guidelines mentioned above, three effective equity adequacy assessment processes were conducted in 2021, 2022 and 2023. The last process considered the evaluation of all material risks of an institution, finalizing the regulatory transition with the determination of Pillar 2 requirements established in Exempt Resolution No. 779 of January 2024.

New Proposal

The new proposal considers the following:

1. Adjust Annex N°1 on banking book market risks so the CMF can demand a capital requirement to achieve a complete and more adequate coverage to the bank's real situation. These include adjustments to the computation of the metrics on the capacity to generate interest and short-term net readjustments (ΔNII) and on the economic value (ΔEVE), definition of atypical banks, and modeling and reporting of prepaid flows in fixed-rate loans subject to prepayment risk.
2. Limit the LSAP's sheet extension.
3. Adjust Annex 3 and instruct its reporting in Excel format.
4. Clarify the determination of internal effective net worth (OI) target and the link with the charge that may be established by the CMF, in accordance with Article 66 Quinquies of the LGB, in addition to the suggestion that the Commission may make regarding the amount that banks should have for their OI.
5. Improve inherent risk profile definition
6. Correct reference to frequency of financial statements to report additional capital requirement level under Article 66 Quinquies.

Concerning the previous version under consultation, the main issues that were raised are clarified and specified. In addition, this new proposal incorporates adjustments to the inherent risk profile and states that the CMF may suggest the amount that banks should have regarding their OI.

As for becoming effective, the proposal considers that adjustments to Annex 1 enter into force for the required from May 2025 with information until April of that year. Amendments to points 2 through 6 will be applied as of the LSAP review process, which will be delivered in April 2026. Finally, the suggestion the Commission may make on additional capital requirement levels (point 4) that banks will have to build up as part of their internal effective capital target may be carried out from the LSAP review process due in April 2027.

Interested parties can visit the **Rules and Norms section** of the CMF Website until November 8, 2024 to check the regulatory proposal in detail and submit their feedback. The Commission also makes available the corresponding **Regulatory Report** assessing its impact.

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