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FINANCIAL DISCLOSURE AND MARKET DISCIPLINE IN THE CHILEAN BANKING SYSTEM

Superintendency of Banks and Financial Institutions
Chile

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Financial disclosure is an essential component of market discipline. The disclosure of reliable, accurate and timely information on the financial condition of banks, enables bank investors and depositors to make informed decisions when allocating their funds. Market discipline involves financial disclosure but is a wider concept. It can be understood as a set of conditions and incentives which lead bank shareholders, as suppliers of capital, and depositors as suppliers of funds as bank liabilities, to take an active stance in monitoring the risks of loss in bank's assets and their solvency.

This note looks at the important role which financial disclosure and market discipline play in the prudential supervision of Chilean banks. The latter seek bank directors and managers to undertake "safe and sound banking" with the view to up-keep the value of bank's asset portfolios, and thus secure payment of their deposits and other liabilities and provide bank shareholders with a fair return on their capital

I. Financial disclosure, market discipline and prudential bank regulation

A reform to the Chilean Bank Law of 1968, and additional changes made in 1997 and more recently, have redesigned bank regulation with the view to make room to financial disclosure and market discipline, and to validate the return-risk relationship in the banking industry on which market discipline is based.

The following main principles underlie Chilean prudential bank regulation:

i) Persons wishing to invest in a bank can do so only if they have sufficient resources of their own.
ii) Board's of bank directors, as agents standing for shareholders, have been entrusted with duties as regards setting up policies and monitoring bank risk.
iii) Disclosure of the financial condition of banks as a factor of market discipline.
iv) Limited State guarantee on deposits which expose depositors to the risk of loss of their funds.
v) Presumptions of financial instability and of bank solvency problems, and self correcting measures, when a bank's capital falls below certain levels.

These principles are explained in more detail as follows.

i) Solvency of founding shareholders and of investors as a condition of entry into the banking system.

Founding shareholders of a bank, or any investor wishing to hold more than ten percent of the shares of a bank, have to show to the Superintendency of Banks

and Financial Institutions of Chile (the Superintendency) that the net worth if their patrimony is larger or at least equal to their intended bank investment. Large bank shareholders are thus unable to buy bank shares just on debt. On this account, they are the first facing risks of loss in case their bank faces solvency problems.

ii) Enhanced responsibilities of bank board of directors.

The Superintendency is following a policy which assigns larger responsibilities to bank directors as regards setting up policies and controlling credit and financial risks, the management of liquidity, the prevention of money laundering and other important bank activities.

As a counterpart to this trend, the Superintendency has introduced a scheme to evaluate banks according to their solvency and the quality of their management. This scheme was tested and became official in 2002.

iii) Disclosure of information on the financial condition of banks.

The disclosure of public information on the financial condition of banks is based on accounting and auditing norms issued by the Superintendency. Banks are required to provide monthly information on their balance sheets and income statements.

Banks have also to publish public information on their risk profile and their capital structures on a quarterly basis. The risk profile of banks has been informed mainly in terms of the credit risk which is embedded in their loan portfolios, based on a standard of five risk categories. In turn, the capital adequacy of banks has been informed since 1997 in terms of the Basel capital index.

To qualify as solvent, the Basel capital index of a bank cannot be lower than the recommended ratio of eight percent. However, to qualify in the highest category of solvency and quality of management, the Basel capital index of a bank must be equal or higher than ten percent. This number is in line with the solvency requirement which large institutional investors, like pension funds and insurance companies, have set in order to invest in deposits, bonds and mortgage letters issued by banks.

iv) Limited State guarantee on deposits.

The State Guarantee on bank deposits refers firstly to time deposits which earn interest. Deposits of individuals in domestic currency are guaranteed up to the equivalent of around US$ 3.000 dollars per person (at the exchanges rate of January 2004), with a limit of 90% in each calendar year.

When the prevailing limited State guarantee on deposits was introduced, it was argued that checking accounts and sight deposits were part of the means of payment of the economy and that they should not be subject to the risk of loss since they would not earn interest. This point of view also led to fully cover time deposits less than ten days due.

v) Presumptions regarding the financial condition of banks and self-correcting measures.

An important norm as regards expected losses is that they must always be fully provisioned. This rule can lead to a negative net result if available income, after administrative and other current expenses, is insufficient to cover required provisions.

If a bank's negative net income erodes its Basel capital index below eight percent, remedial market oriented measures must be put in place, which expose its shareholders as well as its depositors to losses. If a bank's index falls below that percentage but not below five percent, the presumption of financial instability does not allow the bank to increase its loan portfolio, while its shareholders are required to supply fresh capital on a short notice. If the Basel capital index falls below five percent the presumption of severe solvency problems calls upon a committee of bank creditors to capitalize deposits and take other measures to recover solvency. If a bank facing the presumption of severe solvency problems fails to take timely corrective action, it faces the risk of liquidation.

The re-capitalization by shareholders has proved to be an effective measure in order to recover the solvency of a few financial institutions. However, the capitalization of deposits and other measures to recover bank solvency have not been used since these remedial measures were enacted at the end of 1986.

II. Current proposals on financial disclosure, market discipline and prudential regulation of banks.

Changes to the Banking Law, under discussion in the Chilean Congress, enhance market discipline. Time deposits less than ten days due would no longer be counted as part the funds which are protected by the State guarantee, and thus expose depositors to larger losses in case of bank insolvency.

Pillar III of the New Basel Capital Accord is devoted to financial disclosure and market discipline. The Chilean approach to prudential regulation is in line with this pillar, although much will have to be done to meet its ample disclosure requirements.

Pillar I of the New Capital Accord refers to minimum capital ratios. The Superintendence favors adopting in a first stage the standardized approach. The role assigned to risk ratings in determining capital ratios would lead corporate

firms with a healthy financial condition to demand ratings to qualified agencies as lower capital ratios on their exposures also mean lower interest rates. The evidence shows that lower risk rated banks are able to attract funds at lower interest rates, while lower risk rated corporate firms are also able to borrow and to place bonds at lower interest rates.

International risk rating agencies have recently awarded an “A” rating (according to the Standard & Poor’s scale) to the Chilean economy. On this account, some banks established in Chile have already been granted a similar rating and other banks and corporate firms are surely to follow.