DIALOGUE ON BASEL II IMPLEMENTATION

ABAC - SBIF - ABIF

CHALLENGES FOR BASEL II IMPLEMENTATION IN CHILE

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EVALUATION OF THE NEW FRAMEWORK

- A substantial improvement on the existing accord.
- Positive effects on bank management and banking supervision.
- Will be adopted by a great majority of countries (88 out of 107 non G-10 countries have expressed their intention of moving to Basel II).
- Will become a global standard.
- Positive progress to date (high-standard professional work and widespread participation by countries).

BASEL II IS MUCH MORE THAN A NEW FORMULA FOR CALCULATING REGULATORY CAPITAL

- Seeks to improve risk management and banking regulation and supervision around the world.

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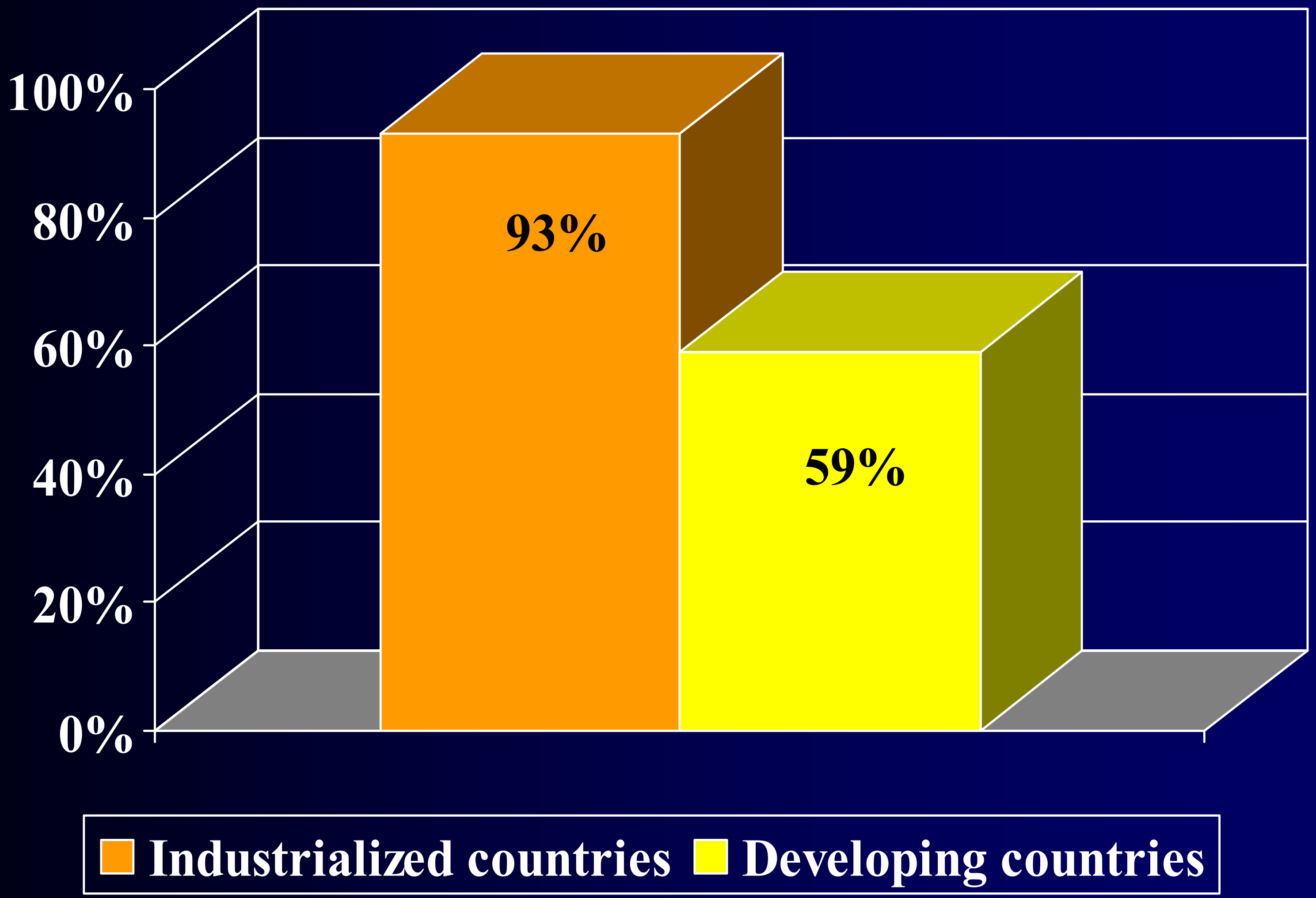
- Covers all relevant issues for risk management and banking supervision.

- Provides an excellent opportunity to raise management and supervisory standards.

THE NEW FRAMEWORK REQUIRES THE FULFILLMENT OF CERTAIN PREREQUISITES

- These refer to the existing quality of bank regulation, supervision, and management.
- Most prerequisites are contained in the Core Principles for Effective Banking Supervision of the Basel Committee.
- In general, developing countries show a relatively low level of compliance with the Basel Core Principles.
- This is a key issue for the implementation of the new framework.

COMPLIANCE WITH BASEL CORE PRINCIPLES BY COUNTRY GROUPING



RECURRENT PROBLEMS IN DEVELOPING COUNTRIES

- Capital over-estimation.
- Credit risk under-estimation.
- Over-valuation of credit risk mitigants (guarantees & collateral).
- Under-provisioning.
- Absence of capital charges for market risks.
- Accounting rules not aligned with international standards.
- Lack of consolidated supervision.
- Attenuating factor: capital requirements over 8%.

CHALLENGES FOR DEVELOPING COUNTRIES

- Implementation must be part of a program aimed at strengthening risk management and banking supervision.

- This requires priorities to be set correctly.

- In some cases, the transition period may take a relatively long time.

ADEQUATE BALANCE BETWEEN PILLARS (1)

- Basel II comprises 3 equally important and mutually reinforcing pillars.

- Pillar I: minimum capital requirements
- Pillar II: supervisory review process
- Pillar III: financial disclosure and market discipline.

- In most developing countries, the main challenges will lie in the implementation of Pillars II and III.

ADEQUATE BALANCE BETWEEN PILLARS (2)

- It will, therefore, be important to establish the right balance between the implementation of the different pillars.

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- It would not, for example, be prudent to move rapidly to the more advanced approaches while weaknesses remain either in the supervisory review process or in financial transparency.

PROVISIONING IS KEY IN DEVELOPING COUNTRIES (1)

- One of the important advances achieved in Latin American countries has been the implementation of loan classification and provisioning systems.
- These are crucial considering the economic fluctuations inherent to the region.
- Basel II does not explicitly deal with provisioning due to differences between jurisdictions in accounting and taxation.

PROVISIONING IS KEY IN DEVELOPING COUNTRIES (2)

- However, the proper management of provisions is essential for advancing in the implementation of the new framework.
- Provisions are related to expected risks (losses), which can be assessed using the same concepts proposed by the new framework.
- In this context, provisioning must, in practice, be considered as a fourth pillar in our countries.

MAIN MACROECONOMIC CONCERNS RAISED BY BASEL II IN DEVELOPING COUNTRIES

- Effects on the level and volatility of capital flows.
- Effects on the length and depth of economic cycles.
- Effects on the behavior of international banking groups, especially due to a lack of recognition of the diversification seen in emerging economies.
- These concerns have not been fully dissipated.

KEY IMPLEMENTATION ISSUES IN DEVELOPING COUNTRIES

- Level playing field.
- Home/host issue (communication and cooperation among supervisors).
- Macro-prudential considerations (country and macroeconomic risks).

THE VIEW OF CHILE'S SUPERVISORY AUTHORITIES ON THE PROCESS OF TRANSITION TO BASEL II

- The transition to Basel II is seen as part of a process that aims to improve and strengthen regulation, supervision, and risk management.
- This is an ongoing process dating back to the aftermath of the crisis of the 80s, when the foundations of prudential regulation and supervision were laid.
- The progress observed in recent years is in line with the recommendations of the Basel Committee and, in particular, with those contained in the new capital framework.

MEASURES TAKEN BY CHILE'S SUPERVISORY AUTHORITIES TO PREPARE THE WAY FOR BASEL II

- External assessment of compliance with Basel Core Principles.
- Reform of the loan classification and provisioning system (Pillar I).
- Implementation of a risk-based supervisory system (Pillar II).
- Convergence of domestic accounting rules with international standards (Pillar III).
- Quantitative assessment of the impact of the new accord on the Chilean banking system.

EXTERNAL ASSESSMENT OF THE BASEL CORE PRINCIPLES

- An external evaluation of these principles, carried out in Chile in 2000, found a 77% level of compliance.

- During the first semester of this year, a new evaluation, carried out by the IMF/World Bank under an FSAP program, found compliance of over 80%.

- As a result, critical points have been clearly identified and some are on the way to being solved.

REFORM OF THE LOAN CLASSIFICATION SYSTEM IN LINE WITH PILLAR I (1)

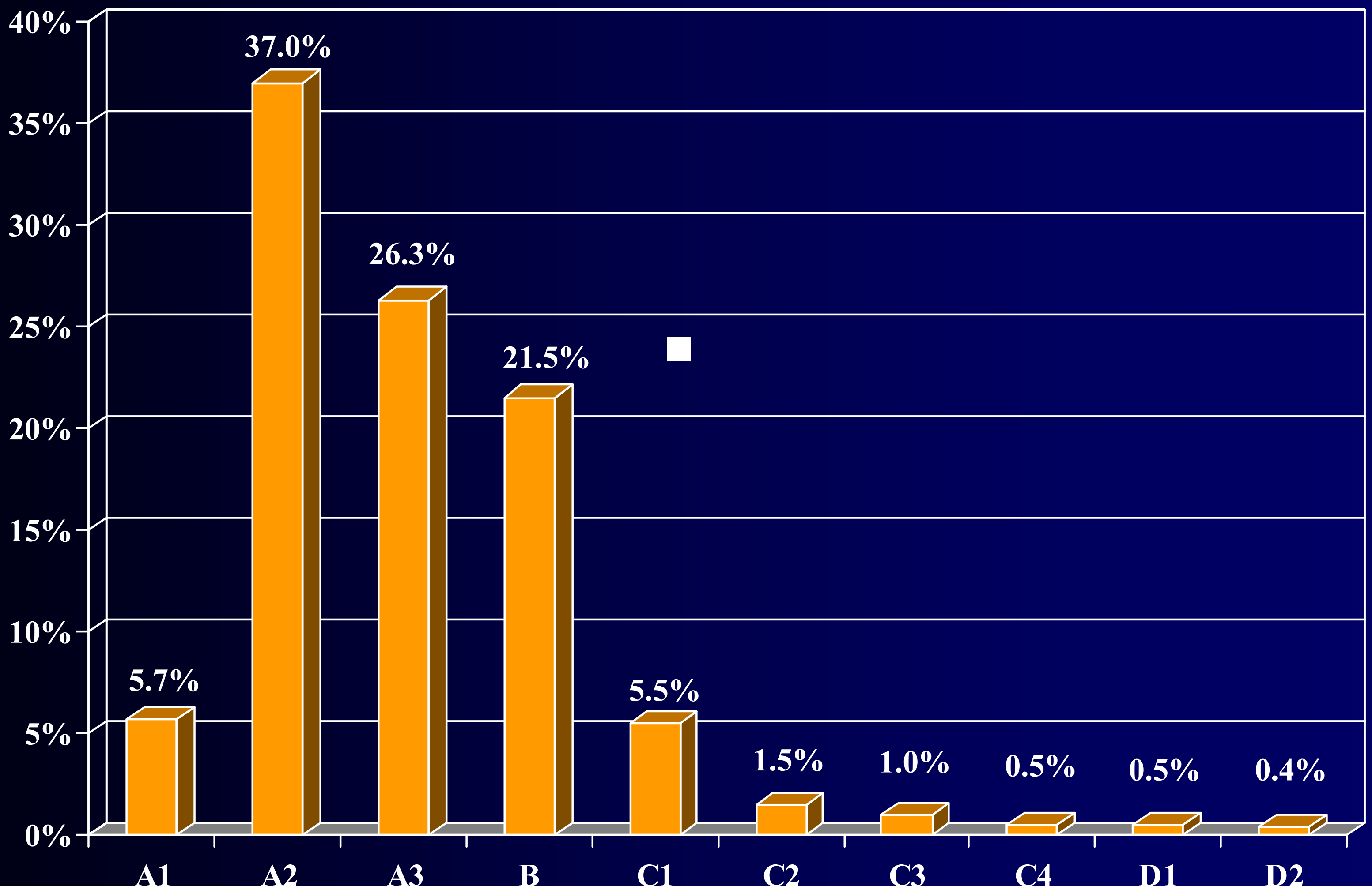
- In force as from January 2004.
- Official scale of 10 categories that permits an adequate level of discrimination and facilitates the supervisory process.
- Permits the use of internal models by banks.
- Considered an effective tool for managing expected risks and provisions.

REFORM OF THE LOAN CLASSIFICATION SYSTEM IN LINE WITH PILLAR I (2)

- Requires the involvement of boards of directors and top managers.
- The full implementation of this reform is considered a necessary condition for moving to the advanced approaches of the new accord.
- First disclosure of information with figures for March 2004.

CHILE: RISK PROFILE OF CORPORATE LOANS ACCORDING TO THE NEW CLASSIFICATION SYSTEM

(FIGURES FOR MARCH 2004)



IMPLEMENTATION OF A NEW SUPERVISION SYSTEM IN LINE WITH PILLAR II

- The new system focuses on management of the relevant risks (credit, market, and operational).

- The traditional system was based on rule compliance.

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- Banks are evaluated periodically and receive an internal rating on a 3-category scale (A, B, and C).

- When weaknesses are observed, corrective measures are recommended and the involvement of the board is required. This is followed up by the supervisor.

CONVERGENCE OF LOCAL ACCOUNTING RULES WITH INTERNATIONAL STANDARDS IN LINE WITH PILLAR III

- This is essential to enhance financial disclosure and market discipline.
- Implementation started last November.
- All deviations from international standards have already been identified.
- An evaluation of the extent and significance of these deviations is currently being carried out.
- Regulations that, for prudential reasons, may need to be stricter than international standards are also being identified.
- The complete implementation of this project will take 2-3 years.

ASSESSMENT OF THE QUANTITATIVE IMPACT OF THE NEW ACCORD IN CHILE

- Chile took part in the QIS 3 with the 3 largest banks.
- Subsequently, a similar exercise was carried out for the whole banking system.
- The evaluation was based on the guidelines of the standardized approach. ■
- The results show that Basel II would not have a major impact on capital requirements.
- In fact, using strict Basel criteria, the study shows a slight reduction in those requirements.

RESULTS OF THE QUANTITATIVE IMPACT STUDY (QIS 3) FOR THE CHILEAN BANKING SYSTEM

Simulation	Credit Risk Impact	Operational Risk Impact	Overall Impact
1. According to strict Basel II criteria	**-13.27%**	**10.33%**	**-2.94%**
2. According to stricter criteria (higher risk weights)	-4.77	10.33%	5.57%
3. According to even stricter criteria (same risk weights as simulation 2, excluding use of credit risk mitigants).	-2.58%	10.33%	7.75%

Notes:

a) The simulation used the standardized approach for credit risk and the alternative standardized approach for operational risk.

b) Figures show the percentage increase (decrease) in capital requirements.

ROAD MAP FOR THE CHILEAN BANKING SYSTEM (1)

- To be published in the last quarter of this year.
- Will be available for comments from the industry and analysts.
- The transition will be stepwise. This implies starting with the standardized approach before moving on to the more advanced approaches once banks have acquired expertise and have sufficient data to validate their models.

ROAD MAP FOR THE CHILEAN BANKING SYSTEM (2)

- In the first stage, adequate management of provisions under the new system is fundamental.
- Capital adequacy assumes adequate provisioning.

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- Progress in managing market risks also needs to be taken into account.
- Likewise, stress testing under adverse conditions, such as interest rate and exchange rate shocks, will be required.

ROAD MAP FOR THE CHILEAN BANKING SYSTEM (3)

- The implications for small banks will be carefully evaluated.

- The home supervisors of branches or subsidiaries of foreign banks will receive full cooperation from Chilean supervisors for Basel II implementation in their jurisdictions.

- However, all banking entities operating in our jurisdiction will be subject to the guidelines of this road map.

Thank you for your attention.