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September 2022

TECHNICAL NOTE ON CRISIS MANAGEMENT AND BANK RESOLUTION

This Technical Note on Crisis Management and Bank Resolution was prepared by a staff team of the International Monetary Fund in the context of the Financial Sector Assessment Program in Chile. It is based on the information available at the time it was completed on August 24, 2022.

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TECHNICAL NOTE

CRISIS MANAGEMENT AND BANK RESOLUTION

Prepared By
Monetary and Capital Markets Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Chile. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at http://www.imf.org/external/np/fsap/fssa.aspx

CONTENTS

Glossary

ASBA	Association of Supervisors of Banks of the Americas
BCCh	Banco Central de Chile (Central Bank of Chile)
BIS	Bank of International Settlements
CMF	Comité de Supervision Financiera (Financial Sector Supervision Committee)
CCP	Central Counterparty Clearing House
CEF	Consejo de Estabilidad Financiera (Financial Stability Council)
CDE	State Defense Council
CSE	Crisis Simulation Exercise
DCV	Depósito Central de Valores S.A.
ELA	Emergency Liquidity Assistance
FSAP	Financial Stability Assessment Program
FSB	Financial Stability Board
GBL	General Banking Law
KAs	The Key Attributes of Effective Resolution Regimes for Financial Institutions (the "Key Attributes"' or "KAs")
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
NCWO	No creditor worse off
MOU	Memorandum of Understanding
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
SBIF	Superintendence of Banks and Financial Institutions (Superintendencia de Bancos e Instituciones Financieras)
SDF	Standing Deposit Facility
SDL	Standing Lending Facility
SP	Superintendence of Pensions
SD	Subordinated debt
IMF	International Monetary Fund
TA	Technical Assistance
TLAC	Total Loss-absorbing Capacity

EXECUTIVE SUMMARY

Chile has a large and well-developed financial system, compared with the rest of Latin America. The market is well integrated into the global financial system, with Chilean firms investing in foreign financial assets, either directly or via institutional investors, and foreigners participating in the Chilean market.

While the financial system is well-diversified, with the nonbank sector accounting for almost 50 percent of assets, the banking sector is very concentrated. Six banks—one state bank, two large private banks, and three foreign-owned banks—account for over 90 percent of banking sector assets. Since the last FSAP, the banking sector has grown from 204 to 300 percent of GDP.

However, there is no statutory resolution regime to facilitate the orderly failure of banks. The existing statutory framework has important limitations as forced liquidation is recognized as unsuitable for managing the failure of a systemic bank or the failure of a bank carrying out critical financial functions (e.g., payment services, custody, or instant access deposit accounts). This is because it results in a loss of access to these services for the banks' customers, causing significant financial and economic disruptions. This represents a significant contingent liability on the State in the form of a high likelihood that the costs of any systemic bank failures would be borne by taxpayers. In addition, the absence of a gone concern loss absorbing capacity requirement for systemically important banks[1] to facilitate orderly resolution also creates a significant risk to financial stability in the event of a future banking crisis.

The BCCh and State guarantees of sight and time depositors, respectively, create significant moral hazard risks. It is widely recognized that deposit guarantees should be industry funded and capped to minimize moral hazard risks. While intended to protect the payments system and preserve depositor confidence, the explicit state guarantees (unlimited in the case of sight deposits) create an expectation of bailout in a crisis. In the event of a systemic bank failure, in the absence of an effective resolution regime, the State and authorities could come under significant pressure to provide state support, despite the statutory limitations on the government and state-owned enterprises capitalizing banks under the General Banking Act (GBL).

Since the 2011 FSAP, there has been significant development in international standards for bank resolution regimes. In 2011, the Financial Stability Board (FSB) established *The Key Attributes of Effective Resolution Regimes for Financial Institutions,* which applies to any financial institution that could be systemically important or critical if it fails.[2] Authorities around the world have developed

[1] The CMF systemic risk buffer requirement on banks is designed to advance prudential resilience objectives not bank resolvability objectives—any future LAC requirements on bank would be in addition to these buffers.

[2] Art 1.1, FSB *Key Attributes of Effective Resolution Regimes*, 2011. This definition includes firms covered by the Basel III D-SIB classification methodology for capital add-on purpose and smaller firms whose failure is judged by the resolution authority to be a risk to the resolution objectives and therefore merits use of resolution tools. Other failed non-systemically important banks can be permitted by the resolution authority to enter liquidation.

resolution powers, including a tool known as "bail-in", which facilitate the imposition of losses on systemic bank capital and debt holders in the event of failure. In addition, banks that are judged to be systemically important or critical if they fail are increasingly required to meet loss absorbing capacity (LAC) requirements similar to the FSB standard on the adequacy of total loss absorbing capacity for global systemically important banks (G-SIBs), known as the *Total Loss-absorbing Capacity (TLAC) Term Sheet*.

The largest Chilean banks are already well-positioned to comply with a future LAC requirement. They have an active track record of issuing of wholesale debt securities, as bond funding makes up 15–20 percent of total liabilities for the largest banks in Chile at the end of 2020. Such bank debt could be relied upon to meet LAC requirements at the point of refinancing, subject to meeting LAC eligibility criteria. Such features of Chilean bank funding structures would position them well to comply with minimum LAC debt requirements to improve bank resolvability in Chile.

Recommended Reforms

Some important reforms to the financial regulatory institutional arrangements have been introduced since the last FSAP. These reforms will help improve coordination, align regulatory standards and supervisory practices, reduce the risk of regulatory arbitrage, and improve existing prompt corrective action or early intervention supervisory regime. Some important limitations remain, including the lack of an ex-ante recovery planning requirement on banks.

However, a clear lesson from the 2008 global financial crisis is that an institution that could be systemically important or critical if it fails cannot be liquidated without significant financial and economic disruptions. Indeed, even relatively small banks can prove critical in stressed financial market conditions. Such risks to the stability of the Chilean financial system in a crisis are all the more pressing given the size of the financial sector (at 300 percent of GDP).

The 2011 FSAP made a number of recommendations to reform the legal framework and to establish a robust bank resolution framework (see Annex II for a summary). Taking into account the significant developments in international resolution policy since then, the recommendations in this FSAP are consistent with and expand on the 2011 FSAP recommendations.

It is imperative that Chile takes advantage of recent policy innovations and establishes an up-to-date bank resolution framework with a range of powers to meet international standards and reduce moral hazard in the financial system. These should include (i) establishing a statutory resolution regime that provides the authorities with the powers to manage the failure of banks, including by bail-in failed bank creditors, and conduct resolution planning for banks (ii) setting a gone-concern loss-absorbing capacity (LAC) requirements for the those banks considered systemically important to ensure their failure can be managed in an orderly manner and (iii) to minimize the moral hazard and central bank balance sheet risks associated with the current unlimited guarantee of sight deposits by the BCCh, an industry-funded deposit protection scheme (DPS) should be introduced with resources and capabilities to implement a rapid payout of covered depositors when failed non-systemically important banks are determined by the resolution authority to enter liquidation.

The range of reforms proposed in this FSAP fall into two broad categories: changes by banks and changes in the legislative and regulatory framework.

Changes by Banks

- **A LAC requirement should be set by the resolution authority for systemically important banks who cannot be placed into an *orderly* liquidation in the event of failure.** LAC requirements are considered an efficient means of enabling the resolution authority to i) recapitalise failing systemically important banks if they fail, ii) protect depositors, and iii) minimize the risk to public funds while ensuring financial stability in the event of a future banking crisis. As discussed above, the largest Chilean banks are already well-positioned to comply with a future LAC requirement.

- **A wider set of powers are needed to enable the resolution authority to require *all* firms within the scope of the resolution regime to make legal, financial and operational changes to their structure necessary to improve their resolvability and ensure the resolution tools can be applied in an orderly manner when banks fail.** Such structural changes are required well before a crisis triggers the application of resolution tools. The objective is to maintain continuity of access to essential banking services, protect depositors, and minimize the risk to public funds by ensuring the failed bank's creditors are exposed to losses instead.

Changes in the Legislative and Regulatory Framework

- **Further enhance cross-authority crisis coordination arrangements, including by agreeing and publishing an MoF, CMF, BCCh crisis management memorandum of understanding ("MoU").** The CMF and BCCH are currently developing such an MoU. This MoU should also describe how authorities plan to prepare for crises in peacetime. It should describe the forum in which this crisis coordination will take place, the full range of crisis management tools available, when different tools would be used, and set a public expectation of which tools are most appropriate for different kinds of banking crisis situations. To support the work of this cooperation in peacetime and in crisis, the authorities should develop a cross-authority systemic impact assessment framework and the wider information sharing arrangements necessary to support coordination.

- **Further enhance the prudential framework to ensure the resilience of systemic firms in stress by establishing a prudential supervisory recovery planning requirement on banks well before crises.** In addition, for non-systemic firms who may be placed into liquidation in the event of failure, the CMF and BCCh should ensure the necessary operational policies, processes, and procedures are in place in peacetime to facilitate the orderly pay-out or transfer to another bank of sight deposits given their importance to the orderly functioning and stability of the payment system.

- **Establish a statutory bank resolution framework with a comprehensive range of resolution tools to manage a future bank failure in an orderly manner, including those classified as domestic systemically important banks or any other financial institution "that could be systemically important or critical if it fails."** Firms within the scope of the resolution regime should be a judgement for the resolution authority, which may consider even a very small firm failure a risk to the resolution objectives (e.g., depositor protection) and therefore merits the use of resolution tools. This statutory regime should define a set of statutory resolution objectives and a full range of resolution tools for managing systemic firm failure (combined with statutory safeguards to ensure their use is appropriately limited). The new regime should also ensure there is a sufficiently clear statutory creditor hierarchy while introducing a statutory depositor preference (general or tiered), as well as an assessment framework designed to clearly identify when a bank is no longer solvent and viable and should enter the resolution regime.

- **Designate a new statutory resolution authority with the powers to conduct resolution planning for banks and to improve their resolvability in peacetime.** This should be done by setting requirements on banks aimed at removing barriers to orderly resolution. There should be adequate structural separation from prudential supervision necessary to ensure the operational independence of the resolution authority and avoid conflicts of interest (perceived or otherwise) between these distinct regulatory functions.

- **Ensure a bank in resolution is able to access temporary collateralized liquidity support if needed.** The standing legislative powers for the BCCh to capitalize any loans to a bank facing solvency problems should be dropped from the statutes. The BCCh should develop its existing emergency liquidity policy framework and the related operational facility capabilities for banks that have been recapitalized through the application of resolution tools. This new BCCh policy should set out the criteria for access, the likely eligible collateral, rate, term of lending under such a facility. Banks in resolution seeking access to BCCh liquidity facilities would need to meet the same BCCh conditions of access as going-concern banks, including being able to demonstrate they have a credible prospect to maintain or restore adequate solvency in the near term.

- **Establish a premium-based partial deposit protection scheme (DPS).** A DPS would help to i) ensure market confidence in a crisis (i.e., by minimizing the risk of runs), ii) support the orderly liquidation of non-systemically important banks and iii) migrate over time to a position where the current BCCh/State guarantees of sight and time deposits can be removed. Transitioning to a DPS will limit the moral hazard and central bank balance sheet risks associated with the current guarantees of sight deposits by the BCCh and term deposits of natural persons by the State. A *prefunded* DPS fund would better insulate the industry from contagion effects related to DPS levies to cover any losses incurred during a future non-systemic bank failure. The new industry-funded DPS should also have the authority to help fund the transfer in resolution of insured deposits backed by the assets of non-systemically important banks[3]. The DPS should be implemented as the new resolution regime is established and have the resources and capabilities to implement a rapid payout of covered depositors when failed non-systemically important banks are determined by the resolution authority to enter liquidation.

- **Expand legal protections to officials involved in crisis management (early intervention and resolution) unless it is based on criminal activity, gross negligence, or bad faith.** It should (i) address CMF, and BCCh staff liability in regulations, and (ii) require gross negligence as the threshold for the civil liability of CMF and BCCh employees and any persons appointed by the CMF (such as inspectors or provisional liquidators).

[3] Such use of DPS funds should be capped. Any DPS funds used to support a transfer should not be greater than the losses the DPS would have expected to incur if it had implemented a payout and made recoveries from the winding up of the institution.

Table 1. Chile: Table of Recommendations		
Recommendations	**Agency**	**Priority***
Crisis Preparedness		
Early Intervention: Establish a statutory ex-ante recovery planning requirement for banks	MoF/CMF	High
Early Intervention: CMF to define internal early warning triggers for prompt intervention in problem banks	CMF	Medium
Early Intervention: Formalize the tools under the existing framework for forced liquidation of failing non-systemically important banks	CMF/BCCh	Medium
Coordination Arrangements: Define and publish an authority Crisis Management Framework	MoF/CMF/BCCh	Medium
Coordination Arrangements: Formalize Inter-Authority Crisis Coordination Arrangements (e.g., MoU)	MoF/CMF/BCCh	Medium
Coordination Arrangements: Establish crisis information sharing and coordination infrastructure	CMF/BCCh	Medium
Coordination Arrangements: Develop a joint CMF/BCCh systemic impact assessment framework	CMF/BCCh	Medium
Resolution		
Establish statutory bank resolution regime, including: statutory resolution objectives, a full range of resolution tools, statutory resolution safeguards, clear statutory creditor hierarchy and depositor preference	MoF	High
Designate an administrative resolution authority (RA) in Chile with the powers to conduct bank resolution planning and set requirements on banks designed to ensure their resolvability in peacetime (e.g., LAC requirements)	MoF	High
Establish a loss absorbing capacity requirement for systemically important banks	MoF/RA	High
Drop from statutes the powers for the BCCh to capitalize any loans to a bank facing solvency problems. Develop an internal emergency liquidity policy and the related operational capabilities, including by setting out criteria for access, the collateral framework, rate and term of lending for banks in resolution	MoF/BCCh	Medium
Depositor Protection Arrangements		
Establish an ex-ante funded premium based partial deposit protection scheme	MoF	Medium
Legal Protections for officials involved in crisis management		
Ensure legal liability only accrues in the event of gross negligence or willful misconduct on the part of the CMF, BCCh and RA, or its employees, including persons appointed by the CMF such as inspectors or provisional liquidators.	MoF	High
* High: within 12 months; Medium: within 1 to 2 years.		

INTRODUCTION

1. **Since the last FSAP in 2011, there has been considerable reform of the financial regulatory institution arrangements in Chile**. The CMF was created in 2017, replacing the former securities and insurance supervisor (SVS) and then merging the banking supervisor into the CMF in 2019, consolidating an integrated supervisor for the Chilean financial market. The CMF also has an objective to ensure the proper functioning, development and stability of the financial market.

2. **The recent reform of the General Banking Law (GBL) set up some new coordination arrangements between BCCh and the CMF in peacetime, including on specific sets of regulations, including the activation of the countercyclical buffer determined by BCCh**. In addition, the banking regulatory framework was revised to increase supervisory powers and expand the early intervention tool kit to the CMF. However, most of the legislative framework which pertains to the financial safety net remains unchanged, and powers for managing crises involving failing banks are narrow.

3. **This FSAP mission is focused on assessing the progress on the establishment, as well as providing further guidance regarding crisis management and the resolution framework for financial institutions, including banks**. The 2011 FSAP noted resolution and crisis management as the areas with the most significant gaps in the Chilean Financial System Regulatory Framework. In reviewing the Chilean crisis management and resolution regime, this technical note seeks to review the existing framework and offer advice to support the Chilean authorities' continued work of further developing their powers and approaches to managing bank failure in a way that is consistent with the context in Chile.

4. **The focus of this technical note is on the financial safety net legal framework and its consistency with international standards and best practice with respect to crisis management and statutory resolution of firms experiencing stress or failing**. In particular, it will review resolution challenges and risks to public funds presented in a system dominated by a handful of large institutions, where liquidation in the event of failure could risk undermining confidence in the financial system as a whole or where it might be difficult to sell such institutions as a whole to other institutions.

5. **The technical note will also provide a discussion of the different approaches available to the Chilean authorities in distributing losses arising in a bank failure and entry into a future bank resolution regime in Chile**. This will include the pros and cons associated with losses being socialized (i.e., absorbed by industry levy payers or taxpayers) or privatized (i.e., absorbed by bank capital holders or unsecured creditors) when banks fail. This will involve a discussion of different approaches to ensuring there are sufficient sources of loss absorbing capacity available to stabilize a failing bank in resolution, including the relevance of the Financial Stability Board ("FSB")'s total loss-absorbing capacity ("TLAC") requirements[4] or similar domestic regimes for Chile's banking sector

[4] Financial Stability Board - *Total Loss-absorbing Capacity (TLAC) Term Sheet*, Nov 2015.

and bail-in debt assessment (if bail-in power were to be established). The technical note will also provide a discussion of the guarantee of sight and time deposits in Chile by the BCCh and State, respectively, and it will propose the introduction of deposit insurance.

6. This note is structured as follows:

- Describes the structure of the existing institutional arrangements.
- Focuses on crisis preparedness, coordination arrangements and prudential early intervention arrangements
- Discusses resolution tools and powers, as well as safeguards including resolution planning and resolvability requirements on banks and liquidity in resolution
- Discusses the role of loss absorbing capacity requirements in making systemically important banks resolvable
- Discusses depositor protection arrangements.
- Discusses legal protections for officials involved in crisis management

EXISTING INSTITUTIONAL ARRANGEMENTS IN CHILE

7. Chile has a large and well-developed financial system. This is reflected in the depth of the financial system, as measured by the ratio of domestic credit to the private sector, as well as in people's access to financial products, such as bank accounts and investment products. The market is well integrated into the global financial system, with the active participation of Chilean firms investing in foreign financial assets, either directly or via institutional investors, as well as foreigners participating in the Chilean market.

8. The total assets of the financial sector in Chile have nearly doubled over the last ten years. It is well-diversified, with the nonbank sector accounting for almost 50 percent of assets. The banking sector is very concentrated,[5] with six banks—one state bank, two large private banks, and three foreign-owned banks—accounting for over 90 percent of banking sector assets (see Annex I for details). The CMF classifies these six banks as systemic under the Basel III D-SIB classification methodology for capital add-on purposes. Long-term bank funding structures are composed of deposit and wholesale funding. While Chilean banks have a high reliance on domestic bond investors in their funding structure, there is also an active foreign investor base in Chilean bank debt.

[5] The CMF considers the structure of the capital charge for banks with systemic importance to generating a RWA incentive, so they do not become too big or complex to fail and manage their capital and their degree of concentration in the different lines of business in order to internalize the costs of its possible failure on the financial system – see CMF, *Basel III Implementation in Chile: Closing Evaluation*, Dec 2020.

Bond funding makes up between 15–20 percent of total liabilities for the largest banks in Chile. Equity market capitalization is equivalent to 65 percent of Gross Domestic Product.

9. **Monetary policy is conducted through mainly open market operations in the overnight funding rate in the interbank market.** The aim is to keep this market rate aligned with the Monetary Policy Rate, which is the rate charged to BCCh in that market. However, the BCCh implements conventional and unconventional monetary policy measures. Commercial banks also play a large role in the short-term financial market. On financial stability policy, the mandate of the BCCh is limited to ensuring the normal functioning of internal and external payments systems, including the role of lender of last resort to the banking system. However, in practice, this gives the BCCh a broad interest in the stability of the financial system overall.

10. **In 2019, Chile's prudential regulatory and supervisory architecture was streamlined through the integration of the CMF and the SBIF**. The aim of this consolidation of the bank supervisor and the securities and insurance company supervisor was to improve supervision on financial markets through better coordination and supervision of the regulatory perimeter and conglomerates. This will help ensure regulatory standards and firm-specific supervision are better coordinated across respective sector-specific prudential supervisors. The CMF also has a statutory objective to supervise the stability of the Chilian financial market. Establishing a single consolidated supervisory authority will help improve coordination between economic authorities, including the BCCh, on financial stability issues, including on crisis management.

11. **The CMF covers prudential supervision, market conduct, and surveillance of most major financial institutions.**[6] The CMF regulates and supervises insurance companies, securities issuers, fund managers, broker-dealers, and financial market infrastructures (i.e., the SSS, the two domestic Central Counterparty Clearing House (CCPs), and the CSD). It also supervises capital markets. CMF also regulates and supervises banks, larger credit unions, credit card issuers and retail payment systems.

12. **In addition to monetary stability, BCCh has a statutory mandate to ensure the stability of the currency and the normal functioning of internal and external payments systems**. As a result, this gives the BCCh both price stability and financial stability statutory objectives if broadly interpreted. To this end, BCCh manages system liquidity through standing facilities and access to settlement accounts in its real-time gross settlement (RTGS) system. BCCh is also the lender of last resort in the Chilean banking system.

13. **The BCCh issues regulations for banks and other depository institutions, regulates, manages and oversees the RTGS system, regulates ComBanc[7] and retail payment systems, and has broad consultative regulatory responsibilities for CCPs and pension funds regulations**. The Superintendence of Pensions (SP) supervises the pension system (pension funds and some social

[6] Pension funds are supervised by the Superintendence of Pensions

[7] ComBanc is a deferred net settlement system which coordinates the delivery-versus-payment process for government securities and where ultimate settlement take place in the RTGS accounts of participants.

security benefits). A Department within the Ministry of Economy supervises smaller credit unions (with capital below US$ 15 million) and is responsible for the regulation and supervision of governance in all credit unions (independent of their size).

14. Cooperation, coordination, and the exchange of information of peacetime supervisory activities in Chile are facilitated through the Financial Sector Supervisory Committee. This forum enables financial sector supervisors (SP and CMF; and BCCh with observer status) to cooperate and exchange information on micro-prudential regulatory and supervisory developments.

15. Cooperation and coordination of financial stability and macroprudential policy in Chile is facilitated via the Financial Stability Board (Consejo de Estabilidad Financiera or "CEF"). The CEF is chaired by the MoF and consists of the CMF and SP. The BCCh is not a formal member[8] but is a permanent advisor to the CEF. In practice, the MoF plays the lead role and holds the technical secretariat. CMF, SP and BCCh prepare work, according to their capabilities and faculties, to discuss at the CEF. While the CEF has powers to request information from its members, including the BCCh, which is necessary for the identification of financial stability risks, its policy recommendations are nonbinding. In addition to high-level meetings, technical staff of the various institutions share information through technical groups under the CEF framework.

16. The BCCh publishes a semi-annual Financial Stability Report. In addition to high-level meetings, technical staff of the various institutions share information through technical groups.

CRISIS PREPAREDNESS

17. The last banking crisis in Chile was in the mid-1980s. During this crisis, three tools were used to address the problems in the Chilean banking system: (i) the liquidation of insolvent banks and financial institutions from 1982 to 1986; (ii) portfolio purchases with repurchase obligation by the BCCh in 1982–1987 and the special legal framework applicable to subordinated debt (Law 19.396, 1995); and (iii) the capitalization of the banking system through the "popular capitalism" process[9], starting in 1985. The BCCh purchase of asset portfolios as a mechanism of improving the bank solvency was limited to those that were judged as solvent but were suffering from a loss of market confidence and finding it difficult to access short-term funding markets. However, these interventions did result in BCCh having a negative equity position for many years afterwards.

18. In 2019, the Bank Holding Company (SM Chile S.A.) of Banco de Chile, through its subsidiary "Sociedad Administradora de la Obligación Subordinada S.A (SAOS), made its final

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[8] The Constitution of the Republic provided autonomy of the BCCh apparently limits its ability to be a full member of the CEF, considering the purpose of such Board and the fact that members of it oversee exercising or overseeing supervisory functions regarding the capital markets, which are not in the sphere of powers conferred to the BCCh. Instead, the BCCh is appointed by law as a permanent advisor to the CEF.

[9] Popular capitalism was a bank recapitalization and reprivatization mechanism set up by the Government of Chile in the mid-1980s. The mechanism consisted of selling new shares of the banks intervened by the authorities to the general public under generous financial and fiscal incentives. Through Popular Capitalism, the government intended to recapitalize the banks and disperse their ownership.

payment on the subordinated debt (SD) owed to the Central Bank since the Chilean banking crisis of the early 1980s. This debt which the SAOS held for over two decades, originated, specifically, in portfolio purchase programs implemented by BCCh in 1982–1987. Thus, the payment in 2019 brought to an end the authorities' intervention to support the Chilean banking system during the last banking crisis in the 1980s. Since the 1980s crisis, no bank has fallen into insolvency.

19. More recently, the Chilean economy has experienced two episodes of financial stress: the first during the period of social unrest in 2019 and the second as a result of the global COVID crisis in 2020, neither of which has resulted in a financial crisis. In order to counter the effects of the social unrest and pandemic, BCCh implemented extraordinary liquidity measures. The expansive stance of monetary policy, achieved through both conventional and unconventional measures, has contributed to maintaining favorable internal financial conditions while resulting in a significant expansion in the central bank balance sheet.

A. Authority Crisis Coordination Arrangements

20. In Chile, the CEF is a statutory body designed to facilitate technical coordination and exchange of information between the MoF, BCCh, CMF, and SP on the prevention and management of crises that present a risk to the financial system and the Chilean economy (Art 1, Law N° 20.789). The CEF is chaired by the MoF, and its secretariat is located within the MoF. While not a formal member of CEF, BCCh provides advice to it on all matters that relate to its mandates, including on financial stability and orderly function of the payment system according to Law 20.789. The CMF is required to inform the CEF of any events in the sector that may have systemic implications without prejudice to the CMF's autonomy. The CEF may also make public communications on crisis management related issues where to do so would help it achieve its purpose and functions. The CEF is required to meet at least monthly.

21. While the CEF provides an effective forum for general crisis communication and coordination between the Chilean financial authorities,[10] it does not have any formal powers or decision-making authority beyond the ability to commission analysis or information from its participants. In recognition of this, the CMF and BCCh are working to agree an MoU that will include information-sharing arrangements and more detail on crisis management protocols, particularly as it applies to CMF decisions to place a firm into a forced liquidation or BCCh decision to provide emergency liquidity assistance to a bank experiencing liquidity stress. The MoU should describe the responsibilities of the authorities for financial stability (both as part of normal supervision and during a crisis) and how decision-making will be coordinated while respecting the legal powers and independence of individual authorities. These new arrangements need to explicitly address the role of the CEF in processes for crisis coordination and decision making. Once such

[10] For example, the 2021 IMF Article IV Consultation Staff Report noted that the Chilean financial authorities have implemented a wide-ranging and largely appropriate set of fiscal, monetary, and financial policy actions in response to the pandemic. The plans have constantly evolved and have greatly benefitted from close coordination between the MoF, BCCh, and the CMF.

arrangements are finalized, a summary version should be published to ensure the market understands the authorities' crisis response framework.

22. To further formalize and operationalize the authorities' crisis management capabilities, the CMF and BCCh, via the CEF and bilaterally, should develop an authority Crisis Management Framework. This framework should describe the authorities' respective statutory roles and objectives in both preparing today for a future crisis and coordinating actions during a crisis, including one involving a bank failure. This framework should describe the range of crisis management tools and measures (i.e., regulatory, early intervention, collateralized liquidity support to solvent banks, asset purchase, future bank resolution regime, forced liquidation etc.) available to the authorities in a crisis including one involving a systemic bank failure.

23. A key aspect of such an authority crisis management framework is that it should set an expectation (at least internal to the authorities) of which authority powers and tools would be used as a bank's proximity to failure increased and set out which tools are appropriate for different kinds of banks (i.e., systemically vs non-systemically important banks). Authorities will need to decide the appropriate actions to take will in a crisis based on the context, including the condition of the bank in question and the wider financial system at the time of its failure. However, developing a shared authority ex-ante expectation for different types of scenarios (e.g., preferred resolution strategies) is important for planning purposes before any crisis. For example, a crisis management framework should make clear the factors the authorities would consider in determining whether a firm can be liquidated in an orderly manner without undermining confidence in the wider financial system. This should be based on a clear description of the legal basis for the different authority measures, which authority has the legal power to implement them, and whether and how they will consult with other authorities before implementing the measure, as well as the operational steps necessary to implement a given crisis management action.

24. An authority crisis management framework should be updated in due course to reflect any future changes in the structure of the financial sector or to the crisis management regime, e.g., the establishment of a resolution regime or DPS. The CMF has already developed an internal guide setting out coordination protocols and template communications with other authorities in the event of a banking crisis. It should look to develop these materials further to establish an agreed policy framework for ensuring orderly bank failure.

25. To support crisis coordination, the CMF and BCCh should also establish a joint approach or framework for conducting systemic impact assessments for individual firms at risk of failure. This framework will help inform the choice between forced liquidation tools and the resolution authority's assessment of whether the firm meets the conditions for entry into resolution in the event of failure. It is typical for systemic impact assessment frameworks to assess the impact of a bank liquidation on capital and funding markets, payment systems, depositors and credit provision to the economy as a whole. Such a framework will need to be supported with the necessary information sharing between the CMF and BCCh in order to conduct an evaluation of the different criteria.

B. Prudential Early Intervention Arrangements

26. Under the General Banking Law, the statutory framework for supervisory early intervention in Chile can be described as having three distinct phases when dealing with banks experiencing severe financial stress: (i) regularization, (ii) appointment of an "inspector" or alternately a "provisional administrator," and (ii) compulsory liquidation. Regularization is initiated upon the determination that a range of triggers set out in Article 112 of the General Banking Law[11] relating to breach of minimum regulatory requirements are met or other indicators of severe financial stress. The CMF maintains forecasts of these indicators, including those related to market prices. On breach of a trigger, the bank is required to submit a regularization plan to the CMF. This plan is designed to set out the actions the firm will take to address the causes of stress and restore market confidence.

27. If a bank's regularization plan is considered insufficient to address the cause of the crisis by the CMF or its implementation fails to improve the bank's situation, then the CMF can appoint an "inspector" or a "provisional administrator." The inspector sits on the board of directors and has a veto right. The "provisional administrator" is granted the same powers of the Board of Directors and CEO of the bank. The appointment of the inspector or the provisional administrator requires the prior consent of the BCCh Board. Finally, the CMF can initiate a compulsory liquidation if the bank is judged to be insolvent at any point, also requiring the prior consent of the BCCh Board. It is also possible for a firm to move directly into liquidation without submitting a regularization plan or the CMF appointing a provisional administrator.

28. These early intervention arrangements provide the CMF with some tools to help banks experiencing stress to take steps to restore their financial position either by engaging in restructuring, asset sales or equity raising. While compulsory liquidation would not normally be included in the definition of early intervention, the CMF's powers to place an insolvent bank into liquidation is likely to be effective for managing the failure of non-systemically important banks.

29. However, the early intervention regime has some limitations. The statutory triggers for requiring a bank to submit a remediation plan set out in Article 112 of the GBL would generally be considered late stage in the bank's lifecycle and illustrative of extreme stress. While the CMF maintains forecasts of Article 112 triggers, firms that are in breach of Article 112 are likely to have a more constrained capacity to improve their financial position to avoid failure. In addition, all the decisions and actions of the provisional administrator appointed by the CMF are subject to legal challenge by the shareholders. While the filing of a legal challenge does not

[11] Article 112 Triggers: (i) capital requirements mandated by law are breached; (ii) losses observed during the past two or more months permit to predict that the bank will breach the capital requirements; (iii) there have been repeated events of noncompliance with the law, regulations or other instruments issues by the CMF; (iv) noncompliance with liquidity requirements; (v) recurrent need of Banco Central de Chile's (BCCh) emergency financing; (vi) it is foreseeable that the bank will not be able to meet its obligations in the next 30 days; (vii) losses that surpass 10 percent of the paid capital and reserves; viii) excess concentration in related party lending or in favorable terms relative to comparable loans; (ix) objections of external auditors to its financial statements; (x) noncompliance with the development plan approved with the granting of the license; and (xi) any other event that could indicate that there is threat to the financial stability of the bank or poor management.

suspend the measures taken by the CMF[12], it could negatively affect the authorities' ability to discharge their statutory duties and exercise their professional judgment without the threat of lawsuits by banks, their creditors or other private actions against their actions. Finally, the CMF's power to appoint a provisional administrator can have limited effectiveness as making such an appointment can often destabilize an open bank (e.g., by triggering a deposit run) in the absence of strong implicit or explicit public support for the bank's liabilities.

30. To further enhance the CMF's existing early intervention powers, it is recommended that the CMF establish an ex-ante recovery planning requirement on banks. Such a requirement should apply at least to firms classified as a D-SIB and any other firm that may be judged to undermine confidence in the financial systemic in the event of its failure and entry into liquidation. Recovery planning should be a prudential requirement on firms (i.e., entirely distinct from any authority resolution planning requirements on firms drawing its legal basis from a standalone statutory resolution regime). It should be the responsibility of CMF supervisors to ensure banks develop robust recovery plans with credible recovery actions to allow them to restore their positions in response to severe stress. Any such recovery planning regime should enable the CMF to require a bank to implement one of its recovery actions set out in the firm's plan if the CMF deem it necessary to avoid failure and the firm's management refuses to take the required action.

31. The CMF should also enhance its internal early warning triggers for prompt intervention in problem banks. CMF should clarify internal early warning triggers to help identify firms at increasing risk of failure, the escalating supervision interventions that would be applied and the deadlines set for remedial action to be taken, and how, if problems were not corrected, intervention would be escalated moving towards resolution. In particular, the CMF should use the firm's recovery plan triggers framework as an input for consideration in developing its own early warning indicators.

32. To enhance the authorities' ability to manage the failure of non-systemically important banks, the CMF and BCCh should work to further formalize the tools under the existing framework for forced liquidation. The CMF and BCCh should establish the operational steps that facilitate the payout or transfer to another bank of guaranteed depositors under title XV of the GBL. This should take into account the BCCh technical reserve that banks are required to hold in central bank securities in accounts at the BCCh against sight deposits in excess of 2.5 times their own funds or equity capital. Any authority expectations of liquidation of non-systemically important banks to facilitate the repayment or continuity of access to sight and term deposits covered by the BCCh and State guarantee arrangements should be published in advance. Equally, the bank-specific information required by liquidation to facilitate a payout or transfer of depositors should be defined (e.g., Single Customer View files), and CMF should test the ability of non-systemically important banks to provide it. These operational procedures should make clear the different approaches available to the liquidator (i.e., payout versus transfer of deposit), the BCCh's role in providing temporary liquidity to the liquidator to facilitate depositor protection in a liquidation (if any), and

[12] Shareholder would require a supporting judicial decision in order to prevent any actions by the administrator.

how such BCCh liquidity might be repaid. Once established, the CMF and BCCh should consider whether to test these arrangements by seeking external advisory review or conducting a simulation exercise.

RESOLUTION AND LIQUIDATION

33. Currently, there is no formal statutory bank resolution regime in Chile as defined in the FSB's Key Attributes for Effective Resolution Regimes ("KA"). The GBL does not provide the CMF or BCCh the statutory powers to "bail-in" a failed bank's creditors; to transfer a failing bank to a private sector purchaser; allow the establishment of a temporary "bridge bank" pending a sale to a new owner; or facilitating the merger of a failed or failing bank with a willing buyer[13]. The establishment of a statutory bank resolution regime had been suggested by the IMF in 2011[14] and 2020[15].

34. The only formal power of the CMF to manage firm failure is limited to the power to require the compulsory liquidation of an insolvent bank. In such a situation, the CMF can make a determination that a bank should not continue operating and declare the bank in a state of forced liquidation. This decision needs the approval of the BCCh. This approval requirement is designed to reflect 1) the possibility that liquidation may have implications for any temporary liquidity assistance provided to the failed bank while it was a going concern, 2) costs associated with payment of the BCCh sight obligations guarantee, and 3) the risk to the stability of the system of placing a large or medium-size bank into liquidation. In a forced liquidation, there are provisions that allow the transfer of credit portfolios, current accounts and other sight deposits to other banks in order to continue their operation and payment. However, liquidation is generally not considered a credible tool for managing the orderly failure of systemically important banks as it results in a termination of the banks' services which can have implications for financial stability.

35. The limitations in the existing financial safety net toolkit may force Chilean authorities to use State resources to avoid a systemic bank failure. While BCCh can only extend emergency loans under specific conditions, one of which is the bank having a credible prospect to maintain or restore adequate solvency in the near term, to this end, the BCCh has some ability to provide solvency support to a failing bank where it is unable to repay central banking liquidity support

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[13] There are some powers available to the CMF under the early regularization regime (Title XIV of GBL) before the formal determination of forced liquidation take place that are intended to facilitate mergers or purchases, sales of assets or syndicated loans to the troubled institution. However, these measures often require the cooperation of the financial institution, its shareholders, and its creditors. Equally, once a firm is in forced liquidation, there are provisions that allow the transfer of credit portfolios, current accounts, and other sight deposits to other banks to continue their operation and payment. However, given that liquidation is generally considered inappropriate for systemically important institutions given the risks it presents to stability of the systemic as a whole such powers in liquidation should not be considered a substitute for statutory resolution powers.

[14] IMF Chile FSAP 2011

[15] IMF Technical Assistance Report – Forming an Integrated Supervisory Authority, Feb 2020

provided (e.g., by capitalizing its credits[16]) before being determined to be insolvent and non-viable. Similar steps were taken by the authorities in the last banking crisis in Chile in the 1980s. Any such interventions to avoid a systemic bank failure are likely to represent a high risk of losses to BCCh (and the State more broadly). The limitations of liquidation as a tool for managing systemic bank failure combined with the absence of any authority tools to impose losses on bank creditors could also create an incentive for the failing bank's shareholders and creditors to refuse to recapitalize a failing bank in anticipation of state support being provided.

36. The resolution of a failing bank in an orderly manner without a loss of confidence in the financial system or reliance on state support requires that authorities be ready to act quickly and manage high levels of uncertainty effectively. Thus, having an established and adequate legal resolution framework and undertaking good preparation in peacetime, well before any crisis, are preconditions for effective crisis management in any jurisdiction.

37. This report recommends the establishment of a new statutory resolution regime which includes the following:

- Bank resolution tools and framework that comply with the Key Attributes
- Designation of a resolution authority
- Resolution planning powers to ensure bank resolvability
- Liquidity in resolution

38. It is understood that the establishment of a bank resolution regime has been considered as part of recent legislative reforms in 2018/19. However, it was decided to progress resolution reforms at a later legislative opportunity. In March 2021, the CMF and the BCCh were involved in a bank resolution crisis simulation exercise (CSE) with five other Latin American authorities facilitated by the Financial Stability Institute of the Bank of International Settlements (BIS) with the support of the Association of Supervisors of Banks of the Americas (ASBA). The CSE was designed to test their financial crisis management arrangements.[17] The CMF is currently in receipt of technical assistance to provide an assessment of its current statutory, regulatory, and institutional capabilities against the FSB KAs.

39. The outcomes of this FSAP report, combined with recent experience and other technical assistance reports, should be used as the basis for a renewed legislative program to

[16] Under Subtitle Two of Title XV of the General Banking Law and Article 36 of the Central Bank Law BCCh is permitted to capitalize any loans to a bank facing solvency problems – to this end, the BCCh has some ability to provide solvency support to a failing bank where it is unable to repay central banking liquidity support provided before being determined to be insolvent and non-viable. If BCCh recapitalizes in this way, it can also sell the shares which result from this capitalisation in a period of three years.

[17] The exercise involved 11 central banks, supervisory authorities and deposit insurers from Argentina, Brazil, Chile, Colombia, Paraguay and Uruguay in a scenario based on the failure of a fictional regionally systemic cross-border banking group.

establish a fit for purpose bank resolution regime in Chile. Such reforms will expand the options available to the authorities in the event of a future banking crisis beyond liquidation and the associated risk to public funds that a limited crisis management tool kit presents in the event of a systemic bank failure.

A. Statutory Bank Resolution Tools and Framework

40. During the financial crisis, governments felt compelled to bail out failing banks rather than risk the negative consequences their disorderly failure would have on the wider economy and financial system, as there were no effective arrangements for resolution in many jurisdictions. In the aftermath of the global financial crisis that began in 2008 and in view of the resulting international policy response, governments around the world decided that securing effective bank resolution regimes was necessary, particularly for cross-border banks, to strengthen the resilience of the financial system to future bank failure or market-wide stress events. Resolution is the process by which authorities can intervene to manage the failure of a bank in an orderly manner.

41. A core principle underpinning the rationale for these reforms is that regulatory systems should not be designed to ensure that banks never fail. Instead, stable and competitive financial systems should be able to ensure that if banks fail, they can do so in an orderly fashion. A bank failure is orderly if it can be implemented without excessive disruption to the financial system or to the banking services provided to the real economy and individuals and without excessive risk to public funds. This principle underpins the FSB's Key Attributes international standard for effective resolution regimes (the 'Key Attributes'), agreed by G20 leaders in 2011. The arrangements for the resolution of failing banks in Chile should be designed to comply with the Key Attributes.

42. While recognizing that such reforms are a major step, it is recommended that a comprehensive legal reform be adopted to establish a bank resolution regime in line with international resolution standards and strengthen the financial safety net in Chile. A statutory reform is needed to help ensure any future banking crisis in Chile can be managed in an orderly way and align with international standards. The most important aspects of a future statutory resolution regime in Chile will include the following:

- Defining clear statutory resolution objectives;
- Defining the firms within the scope of the regime;
- Providing a range of statutory tools for the resolution authority for managing bank failure;
- Defining a framework to assess the resolution conditions;
- Setting clear creditor safeguards; and
- Clear statutory creditor hierarchy.

43. More detail on each of these points is set out below. Annex III also provides a high-level comparison of the same resolution regime design principles for the U.K. and the U.S.

44. On resolution objectives, the resolution authority should operate within a statutory framework that gives it legal powers to resolve banks in order to achieve clearly defined statutory resolution objectives. The resolution objectives should include (1) ensuring the continuity of banking services and critical functions in Chile, (2) protecting and enhancing the financial stability of Chile, (3) protecting depositors, (4) protecting public funds by ensuring losses are imposed on the failed banks' creditors, and (5) avoiding unnecessarily interference with property rights.

45. On the scope of the regime, it should cover any financial institution "that could be systemically important or critical if it fails."[18] This may include institutions that are much smaller than those captured by the Basel III D-SIB classification methodology for capital add-on purposes. It could include very small firms if they provide a critical economic function (e.g., instant access deposit-taking). Ultimately, it should be for the resolution authorities to judge whether even a very small firm failure is a risk to the resolution objectives (e.g., depositor protection) and therefore merits the use of resolution tools.

46. The flexibility to use resolution powers on very small non-systemically important firms will need to be judged against the resolution objectives and safeguards. The use of resolution tools allows the resolution authority to interfere with private property rights, given the public interest in maintaining financial stability. However, if a firm is not systemically important, it may be more difficult to demonstrate how its entry into liquidation would present a risk to financial stability. Equally, such small firms will have limited unsecured liabilities that are not covered by depositor protection arrangements available to absorb losses in resolution. Therefore, if resolved, alternative sources of loss-absorbency will be required. This may create a risk to public funds in the absence of alternative sources of loss absorbency (e.g., pre-funded DPS funds or other resolution funds) to fund the transfer of depositors in resolution. The resolution regime should also extend to the holding companies and affiliated operational entities of financial institutions (e.g., group service companies).

47. On resolution powers and tools, the RA should be provided with a range of resolution tools, such as mandatory recapitalization, mergers, transfer of assets and liabilities (purchase and assumption transactions, bridge banks), or mandatory debt restructuring. These powers should not only provide the administrative and operational control of the entity but also ensure that the authorities can assume all shareholder's rights (essential for the undertaking of these resolution measures.) The authorities could further explore any possible constitutional implications of the suspension of shareholder's rights during this phase.

[18] Art 1.1, FSB *Key Attributes of Effective Resolution Regimes*, 2011. This definition includes firms covered by the Basel III D-SIB classification methodology for capital add-on purpose and any smaller firms whose failure is judged by the resolution authority to be a risk to the resolution objectives and therefore merits use of resolution tools. Other failed non-systemically important banks can be permitted by the resolution authority to enter liquidation.

48. The new statutory resolution tools should provide the administrative powers to (1) transfer shares and property to a private sector purchaser,[19] (2) transfer shares or property to a bridge bank on a temporary basis to facilitate an onward sale, (3) bail-in creditors without ex-ante consent but subject to ex-post appeal as a means of recapitalizing failing banks. It should be clear in the legislation that the resolution powers are also applicable to medium and small-sized banks where such firms being placed into orderly liquidation proceedings would undermine the resolution authority's statutory objectives.

49. As a last resort option, the legislation should provide the MoF to take a failing systemic firm into temporary public ownership (TPO) but only if the resolution authority is unable to apply the other resolution tools in a way that is consistent with the resolution objectives. The authorities should set a high bar for any use of the TPO tool by exhausting all other resolution options first. Use of the TPO tool should be required to demonstrate that failure to TPO a failing bank would be a serious threat to the stability of the financial systems. It should also ensure creditors of a failing firm taken into TPO are bailed-in and bear considerable losses first. However, it is prudent to not tie the authorities' hands in responding to a systemic banking crisis as it is not possible to predict the circumstances of a future systemic bank failure.

50. A TPO tool entails the highest risk to public funds of any resolution tool and can result in moral hazard that needs to be carefully considered. The establishment of a Loss Absorbing Capacity ("LAC") requirement for banks is the most important step that can be taken to ensure public funds are protected from risk by ensuring creditors are exposed to loss in the event of a bank resolution, including TPO. However, it is prudent to ensure that the MoF and financial authorities, including the future resolution authority, have in place an appropriate legal framework (e.g., enabling powers in legislation, operationalized via a memorandum of understanding) to facilitate swift mobilization of solvency support actions and funding when needed as a last resort given it is not possible to predict all forms of future crisis and the authorities must be able to respond to all risks to the stability of the financial system. The form of such solvency support arrangements should be agreed in advance and structured to preserve the independence of BCCH and future resolution authority.

51. In recognition of the large number of foreign banks operating in Chile where the resolution will be led by the resolution authority in the home jurisdiction in coordination with host authorities, it will be important for any future RA in Chile to have the power to recognize or support a foreign resolution action with respect to a foreign bank with operations (i.e., branches or subsidiaries) in Chile. The October 2016 FSB Key Attributes Assessment Methodology for the Banking Sector[20] resolution recognition involves an authority accepting the commencement of a foreign resolution proceeding domestically and thereby empowering the relevant domestic

[19] Transfer powers include the power to transfer shares of a bank as well as packages of a bank's assets and liabilities to a private sector purchaser. This is often referred to as Purchase and Assumption (P&A) in a US context. The same powers can be used to transfer shares, assets or assets and liabilities to a temporary bridge bank if judged necessary in order to facilitate an on-ward share to a private sector purchaser.

[20] Link: http://www.fsb.org/2016/10/key-attributes-assessment-methodology-for-the-banking-sector/

authority to enforce the foreign resolution measure. Recognition is not dependent on the exercise of resolution powers in the local jurisdiction. Instead, the overall objective is to ensure recognition of a foreign resolution action produces substantially the same legal effect in Chile as if it had been made (and been authorized to be made) under domestic laws. Supportive resolution measures involve the taking of resolution measures under the domestic law to produce the effect of the resolution measure taken by the foreign resolution authority.

52. Any such powers to support foreign resolution actions are subject to safeguards consistent with those in the Key Attributes. For example, a foreign resolution action must not be recognized unless an arrangement exists with the foreign authority under which the eligibility of Chilean creditors or shareholders to claim compensation is broadly consistent with their eligibility to claim NCWOL compensation under Chilean legislation. Recognition must also not be granted where it would adversely impact Chilean financial stability, would not deliver outcomes consistent with Chilean resolution objectives, or would disadvantage Chilean creditors or shareholders relative to other creditors or shareholders in the resolved bank.

53. It will be essential for the future resolution regime in Chile to establish a clear mechanism for determining whether a firm has met the conditions for entry into resolution. In the first instance, two conditions must be judged met before a firm can be taken into resolution: 1) the firm is failing or likely to fail, and 2) it is not reasonably likely that action will be taken that will result in the firm recovering. The first determination should be made by the supervisory authority, the CMF, following consultation with the resolution authority as designated, BCCh and MoF. The second determination should be made by the resolution authority in consultation with the prudential supervisory authority, BCCh and MoF. If both conditions are judged to be met by the respective authorities, then the resolution authority can place the firm into the resolution regime, e.g., as necessary to minimize resolution costs or preserve financial stability.[21]

54. On statutory resolution safeguards, it is important to establish clear limits on the resolution authority's uses of its powers to affect the property and other contractual rights of counterparties and investors in the failed firm during the resolution. These safeguards need to include requirements on the resolution authority to 1) ensure no shareholder or creditor is left worse off ("NCWO") than they would have been had the failed bank been placed into a liquidation or insolvency procedure, 2) conduct an independent valuation of the firm's assets and liabilities prior to the use of resolution powers to inform the no creditor worse off protections, and 3) respect netting, set-off or collateral arrangements. It should be clear in the resolution framework that shareholders and creditors should have a right of ex-post appeal for compensation to the MoF against the actions of the resolution authority if their treatment in resolution leaves them worse off than if placed into liquidation.

[21] If the authorities decide to limit the resolution regime to banks deemed systemic at the point of failure, Fund staff recommend that the powers to transfer deposit liabilities and assets out of a failed bank (the so called 'P&A powers') be available even for non-systemic banks. This is because they entail less disruption to depositor services and tend to be less costly to the deposit insurance scheme then liquidation and depositor payouts.

55. On statutory creditor hierarchy, the statutory resolution regime should ensure there is a sufficiently priority or hierarchy of creditor claims in insolvency or a winding-up to support orderly resolution. Currently, in Chile, the creditor hierarchy is not sufficiently clear on the interaction between the GBL and wider corporate insolvency legislation in assessing the appropriate treatment of bank creditors in a liquidation. This is essential to inform the application of resolution actions with the certainty of impact on creditors (i.e., being able to impose losses on creditors in order with the hierarchy) and also to assess that no creditors are worse off (NCWO) than they would have been if the bank had been allowed to enter liquidation. In considering the clarification of the statutory creditor hierarchy, the authorities should adopt a statutory depositor preference that aligns with eligible depositors and protected levels provided by the DPS protection regime once introduced. Finally, such a clearly defined statutory understanding of creditor claim in resolution will decrease the risk of disorderly market behavior on entry of a failing firm into the resolution regime due to a lack of certainty related to the impact of resolution on different classes of creditors. Annex V provides an illustrative bank creditor hierarchy for information.

B. Designation of the Resolution Authority

56. The FSB Key Attributes state that jurisdictions should have a designated administrative authority or authorities responsible for exercising the resolution powers over failing firms within the scope of the resolution regime. A key design consideration is that the resolution authority should be an administrative authority. That is to say, judicial actions should not constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. In sum, the scope of judicial review should be limited by law. Instead, judicial reviews can be conducted on the procedural aspects of resolution authority decision making, not the substantive aspect of the RA's decision (i.e., bail-in versus property transfer)[22]. It should not be possible to nullify, modify, or revise a resolution action taken by the RA to manage the orderly failure of a systemic bank through the courts. Instead, the only remedy available for affected parties would be monetary compensation by the Government.

57. There is no single institutional model for a resolution authority, and different jurisdictions have taken different approaches to reflect their existing institutional arrangements of the regulatory bodies and the nature of their domestic banking system. There are four broad models that can be considered when designating a new resolution authority:

- establish a new standalone agency (e.g., Federal Deposit Insurance Corporation in the US, Single Resolution Board in the European Banking Union)

[22] The FSB Key Attributes note that legislation establishing resolution regimes does not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead, it provides for redress by awarding compensation, if justified.

- establish the resolution authority within the prudential regulator with the appropriate operational independence from prudential supervision (e.g., FINMA in Switzerland, BAFIN in Germany))

- establish the resolution authority within the central bank (e.g., Bank of England, Hong Kong Monetary Authority, Monetary Authority of Singapore with the appropriate operational independence from prudential supervision and lender of last resort functions within the central bank)

- Establish the resolution authority within the depositor protection agency (where one already exists) (e.g., PIDM in Malaysia) (not relevant in Chile).

58. Regardless of the institutional model pursued, adequate structural arrangements are necessary to ensure operational independence of the RA and avoid conflicts of interest (perceived or otherwise) between the functions of prudential supervision and the functions of the RA. The purpose of this requirement is to ensure that conflicts of interest (perceived or otherwise) between prudential supervisory objectives (i.e. firm resilience) and the RA's objectives (i.e. firm resolvability), for example:

- In a crisis, there may be a risk of regulatory forbearance where a supervisor acts as RA for the purpose of determining whether the second condition for resolution is met (i.e., whether there is a reasonable prospect of the bank's recovery)

- In peacetime, a direction by the RA to remove impediments to resolvability (e.g., changes to legal, operational or financial structures of a bank) may have high potential costs (and therefore prudential) implications for the firm;

- Setting the particular level of the minimum LAC required may also have prudential implications (e.g., by disincentivizing cheaper sources of funding, such as retail deposits, and thereby impact the firm's capital position or implications for a firm's leverage ratio).

59. The requirement for the structural separation of the RA should be seen as the means for achieving the objective of avoiding conflicts of interest with supervisory or other authority objectives. Any such arrangements must be "adequate" for that purpose. In order to be adequate, at a minimum, there must be operational independence between the supervision and resolution functions. Ensuring operational independence of the resolution authority from the supervisory authority requires both separate:

- <u>staff and leadership of the same seniority</u>: This must involve structural separation of staff involved in those functions, as well as separate reporting lines; and

- decision making/governance framework: The resolution authority must be able to take the decisions needed to discharge its responsibilities without the consent of any supervisory authority

60. It is important to note that this does not prohibit close cooperation or information sharing between the supervisory and resolution functions of the authorities. Instead, the operational independence of the resolution authority is necessary to ensure resolution issues are prioritized in wider authority engagement with firms. Ideally, supervisor and resolution authority officials should have seamless access to the same firm-specific information where relevant to their respective functions. Indeed, there should be clear statutory information sharing gateways in the resolution legislation to facilitate the required close cooperation between supervisors and the resolution authority when working to improve banks' resolvability in peacetime and coordinating their respective actions in a crisis.

61. While no statutory resolution framework exists in Chile, it is assumed that while any resolution public communications may be centralized through the CEF, the CMF may be the lead authority in the resolution of a failing bank under a future statutory resolution regime. This role is well aligned with the CMF statutory objective to ensure the proper functioning, development and stability of the financial market. While it would not prevent the CMF from being designated as the RA in the future, any such RA function within the CMF would need to be structurally separate from the CMF's prudential regulatory and supervisory functions. As a micro-prudential supervisor, the CMF will have a good understanding of the structure of Chilean banks which would be an aid in work to improve their resolvability.

62. Alternatively, there may also be synergies in designating the BCCh as resolution authority given its high level of operational independence from prudential supervision and government. BCCh also has a statutory objective to ensure the normal functioning payments systems, which is closely aligned with Chilean financial stability, a core objective for any resolution regime. In addition, the fact that the BCCh is the lender of last resort as well as guarantor of sight deposits, it is incentivised to drive forward the hard work of improving bank resolvability in peacetime to ensure orderly bank resolution is feasible and credible in order to minimize the risk to its balance sheet in a crisis. However, it would be important to ensure operational independence of the resolution authority function with the BCCh so there is no perception that BCCh would engage in open market operations beyond its monetary policy objectives to avoid firms entering resolution.

C. Resolution Planning Powers and Bank Resolvability

63. As there is no statutory resolution regime in Chile and no designated administrative resolution authority, there is also no statutory resolution planning powers to allow the authorities in Chile to prepare for the orderly failure of firms. This report recommends that a future resolution regime in Chile should provide the resolution authority with a statutory objective to engage in resolution planning well in advance of firm failure for all institutions within its scope. The resolution authority should be provided with specific resolution planning powers to:

- gather information from the bank (i.e., legal, financial and operational structure);
- set and operationalize a preferred resolution strategy for the bank.
- assess the bank's resolvability under that preferred resolution strategy designed to identify any barriers to its orderly implementation; and
- address bank-specific barriers to resolution, e.g., a rule-making power or firm-specific power of direction.

64. **Statutory resolution planning powers are necessary to enable the resolution authority to conduct resolvability assessments and require firms to take action to remove any barriers to the orderly application resolution powers in the event of the firm failure**. Authorities will need to decide the appropriate actions to take will in a crisis based on the context at the time, including the condition of the failing bank in question and in the wider financial system. However, developing a shared authority ex-ante expectation or preferred resolution strategy for different types of scenarios (e.g., preferred resolution strategies) is important for planning purposes before any crisis. To this end, resolution planning powers should include a power for the resolution authority to make rules to require banks to make the necessary legal, financial and operational structure changes in order to remove impediments to resolvability, i.e., to set resolvability standards for banks, including a LAC requirement.

65. **While it may be possible for the CMF to use its powers as a prudential supervisor to advance resolution planning objectives in some instances, given its statutory objective to ensure the proper functioning, development and stability of the financial market, there may be limits to this approach where there is a conflict with prudential objectives**. Even if it is possible to use CMF prudential powers for the purposes of resolution planning and removal of barriers to resolvability in Chile, it is essential to have a separate statutory basis for the resolution authority's resolution planning and resolution implementation responsibilities, including the power to make rules to require firms to remove barriers to their resolvability well in advance of their failure. This is important in order to manage the potential conflicts of interest between resilience and resolvability objectives for banks in Chile.

66. **The RA will conduct resolution planning for individual banks within the scope of the regime well in advance of any actual failure.** The CMF has already started to engage with some firms on resolution planning topics recently. Annex IV provide some additional detail on the respective roles and responsibilities of the supervisory authority as distinct from those of the resolution authority.

D. Liquidity in Resolution

67. **In addition to ensuring systemically important banks in resolution can be recapitalized by imposing losses on TLAC, it is essential to ensure banks in resolution have sufficient liquidity to meet their obligations as they fall due.** In the first instance, banks in resolution will be

expected to meet any liquidity needs from their own private resources. However, where the bank's liquid resources are insufficient, or they are unable to access normal private funding markets in the initial phase of the resolution, the resolution authority needs to be able to provide temporary liquidity assistance in order to ensure the overall resolution strategy is orderly. Such liquidity in resolution support should be secured against a wide range of collateral.

68. The BCCh can extend emergency liquidity assistance (ELA) to banks[23], although it has not done so since the mid-1980s. While the MoF is closely sighted on any decision by BCCh to grant ELA, the MoF cannot stop a decision by the BCCh to provide ELA to a bank in stress[24]. The MoF does not indemnify the BCCh for any losses that may arise from ELA. If BCCh does extend ELA to a bank, it is able to dictate the terms and conditions for granting ELA, including collateral eligibility. However, BCCh's internal policies and procedures for the deployment of ELA require further development to be consistent with international best practice, including further clarifying the regulatory framework for ELA and internal BCCh ELA operations, e.g., solvency and viability assessment frameworks, risk control measures documentation and accountability. Amongst other changes, BCCh rules should make clear that ELA should be reserved, as a last resort, to solvent banks facing temporary liquidity issues. BCCh ELA should be accompanied by a government guarantee when liquidity support is provided to a bank with uncertain solvency or under some resolution scenarios (e.g., where the firm's post-resolution restructure plan designed to restore its business model viability may be more in question). The standing legislative powers for the BCCh to capitalize any loans to a bank facing solvency problems should be dropped from the statutes. See the IMF Chile FSAP Technical Note on Systemic Liquidity for more detail.

69. Considering BCCh's role as lender of last resort in the context of resolution, the BCCh should also clarify how lending under its existing ELA facility can be tailored or adapted to ensure banks recapitalised via resolution can access temporary collateralized liquidity support if required. In considering how to provide liquidity in resolution if required, it should build on and expand, if necessary, the BCCh's existing bilateral lender of last resort liquidity facility capabilities.

70. BCCh should also consider how any such liquidity support for resolution purposes interacts with its wider normal lending facilities and how risks to the central bank balance sheet would be managed by strengthening its collateral and risk management frameworks. BCCh should develop an internal emergency liquidity policy and the related operational facility capabilities for banks that have been recapitalised through the application of resolution tools, including by setting out the criteria for access and agreeing on joint assessments of firm solvency and viability with the CMF, the collateral framework, rate, and term of lending.

[23] Section 36 of the Basic Constitutional Act Central Bank of Chile notes extension of the term of such credits by the BCCh shall require the prior opinion of the CMF.

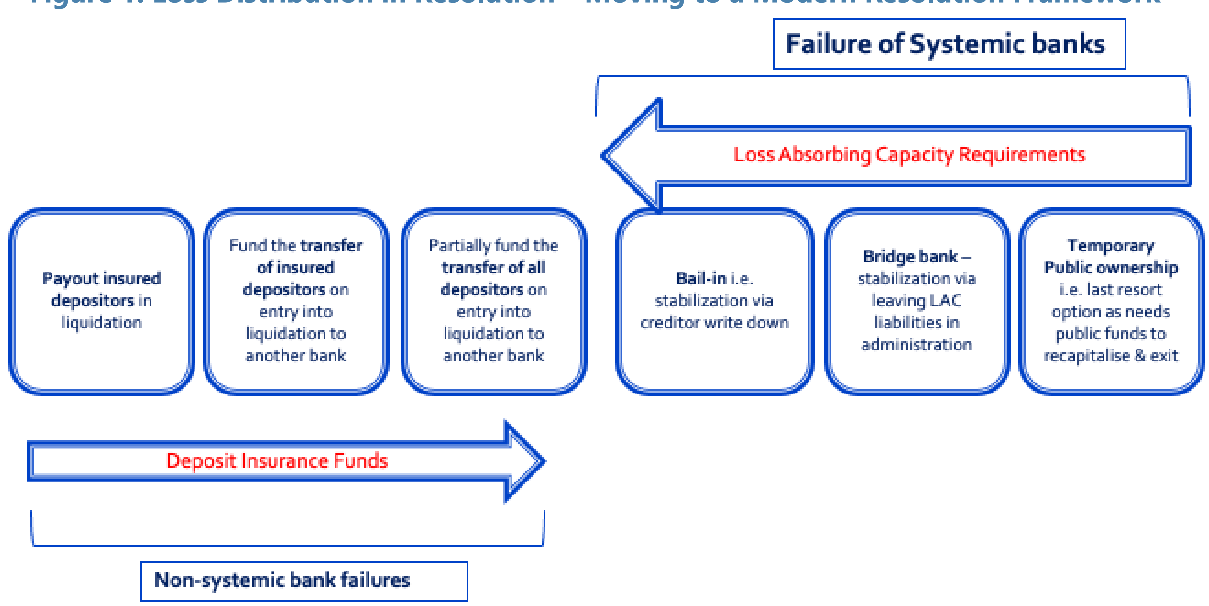
[24] Section 19 of the Basic Constitutional Act Central Bank of Chile notes that Minister can attend BCCh board meetings, offer suggestions, and have the right to suspend the applicability of any decision or resolution passed by the BCCh Board for a period not to exceed 15 days. However, if all BCCh Board Members disagree with the proposed suspension, it has no effect.

LOSS ABSORBING CAPACITY REQUIREMENTS FOR SYSTEMICALLY IMPORTANT BANKS

71. In light of the highly concentrated nature of the Chilean banking system, the report recommends that a LAC requirement is set for any bank that could be systemically important or critical if they fail as the most efficient means of ensuring sufficient loss absorbing capacity to stabilize these banks in a resolution. Establishing a LAC requirement to facilitate the orderly resolution of systemically important banks by imposing losses on the failed bank's capital and debt holders is also judged more consistent with the RA statutory resolution objectives to protect public funds. It may also be considered a more efficient source of loss absorbency than requiring industry to contribute to an ex-ante resolution funds of sufficient size to resolve a number of failing systemically important banks. Instead, LAC resources remain on the bank's balance sheet to fund business in peacetime.

72. LAC requirements will reduce the direct link between financial sector risk and sovereign risks as they reduce the risk of needing to pay out under the existing deposit guarantees in the event of systemic bank failure. LAC requirements will also reduce moral hazard risk in the banking sector by ensuring the risk of their activities is internalized by its shareholders and creditors, consistent with the "polluter pays" principles. This improved alignment of incentives to manage risks associated with banks' activities will also support a more efficient allocation of capital in the economy by helping to minimize moral hazard risk.

Figure 1. Loss Distribution in Resolution – Moving to a Modern Resolution Framework

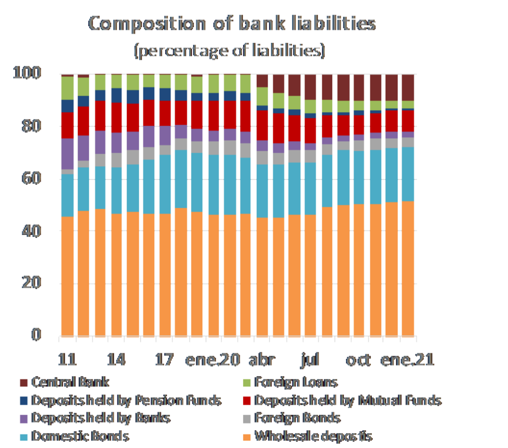


Source: Modified from IMF Technical Note "*Resolution Funding : Who Pays When Financial Institutions Fail?*", 2018

73. A minimum LAC requirement for systemically important banks is a requirement to maintain equity and eligible debt liabilities (e.g., capital and senior unsecured bonds) that can credibly bear losses before and in resolution, for example, through being written down and, or, converted to equity. Similar to the FSB's TLAC requirements (link), the UK's minimum requirement for own funds and eligible liabilities (MREL) requirement (link), the Hong Kong Monetary Authority's Loss-Absorbing Capacity requirement (link), the proposed minimum LAC requirement will include a minimum one-third debt requirement (as opposed to common equity tier 1 (CET1)). CET1 automatically absorbs losses on an ongoing basis. As such, it is typically regarded as the 'best' form of capital. However, a consequence of this is that by the time a bank reaches the point of failure, it is likely that much of its CET1 will have been depleted. LAC debt is not at risk of depletion before failure and provides a fixed quantity of financial resources that can support an orderly resolution. It is proposed that any entity that is subject to a LAC requirement must meet at least one-third of it with LAC debt.

74. The purpose of a LAC requirement is to help ensure that when banks fail, that failure can be managed in an orderly way, minimizing risks to financial stability, disruption to critical economic functions, and risks to public funds. In other words, banks can be 'resolved', where necessary, when they fail. It is important to note that not all types of liabilities are suitable for this purpose. Some liabilities will be connected to critical economic functions (e.g., deposit-taking etc.), and others will not be reliably available at the point of resolution (e.g., debt liabilities with a maturity of less than one year).

Figure 2. Composition of Chilean Bank Debt Liabilities[1]



Source: Own elaboration based on information from the Central Bank of Chile and the SBIF.

CONSOLIDATED LIABILITIES BY INSTITUTIONS - DECEMBER 2020
(Amounts in millions of pesos)

Institutions	Debt instruments issued				Total Liabilities
	As % of Total Liabiliti	Total	Current Bonds (Ordinary	Subordinated Bonds	
Banco de Crédito e Inversiones	13.95	7,431,624	6,166,461	1,258,653	**53,261,594**
Banco Santander-Chile	15.74	8,204,177	6,749,989	1,357,539	**52,123,478**
Banco del Estado de Chile	17.62	9,006,330	7,458,817	1,024,209	**51,100,095**
Banco de Chile	20.28	8,593,595	7,700,402	886,407	**42,368,863**
Scotiabank Chile	19.73	6,765,390	5,917,945	730,285	**34,290,415**
Itaú Corpbanca	18.63	6,204,856	5,092,979	1,081,031	**33,299,164**
Banco Bice	21.56	1,828,900	1,610,640	217,397	**8,484,016**
Banco Security	39.51	2,930,589	2,571,801	347,802	**7,417,778**
Banco Consorcio	26.09	1,387,999	1,145,946	242,053	**5,319,119**
Banco Falabella	5.42	269,804	175,264	30,183	**4,980,870**
Banco Internacional	26.52	883,607	736,599	134,483	**3,331,339**
Banco BTG Pactual Chile	15.70	276,757	203,130	73,627	**1,762,922**
HSBC Bank (Chile)	0.00	0	0	0	**1,422,852**
Banco Ripley	20.30	194,989	174,415	0	**960,631**
JP Morgan Chase Bank, N.A.	0.00	0	0	0	**689,481**
China Construction Bank, Agenc	0.00	0	0	0	**118,170**
Bank of China, Agencia en Chil	0.00	0	0	0	**15,813**
Banco do Brasil S.A.	0.00	0	0	0	**9,897**
Banking System		**53,978,617**	**45,704,388**	**7,383,669**	**300,956,497**

Source: CMF - Banks and Financial Institutions

[1] The total debt instrument number in the Consolidated Liabilities By Institution Table also includes Letters of Credit and Mortgage Bonds which have not been show in the table as there are very small and not related to LAC issues. The underlying data in the table is derived from the CMF monthly report – see link: https://www.cmfchile.cl/portal/estadisticas/617/w3-propertyvalue-43347.html#estadisticas_bancos

75. The largest Chilean banks are already well-positioned to comply with a future LAC requirement given the active track record of issuing wholesale debt securities, which can be

made to be LAC eligible when refinanced in due course (See Figure 2 for detail). The Pre-2019 crisis is likely a better reflection of long-term bank funding structure, which is more conducive to meeting a future LAC. For example, for the largest banks in Chile, bond funding makes up a significant proposition of total liabilities, ranging between 15 to over 20 percent in cases. However, there is a high reliance by Chilean banks on domestic investors, including pension funds[25] as investors in their bond issuance. Without the appropriate LAC disclosure requirements on banks and active risk management by pension funds to manage concentration risk in bank debt, this could raise concerns about the impact of imposing losses on LAC on pensioners when a bank is resolved. That said, there is also an active foreign investor base in Chilean bank debt which is likely to be interested in the higher return provided by LAC debt issuance.

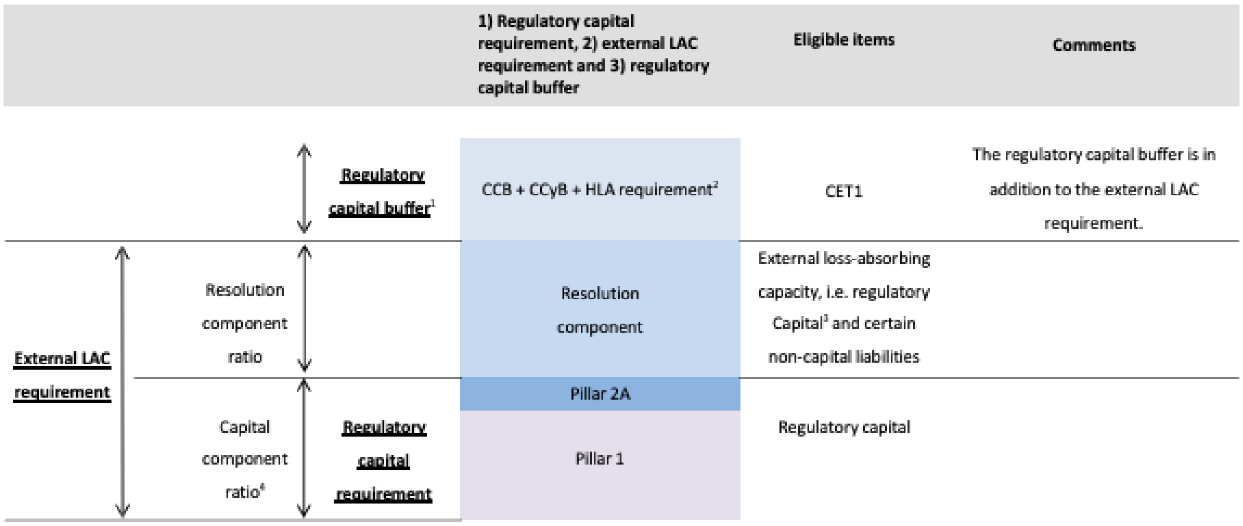
76. In order to establish a LAC requirement for Chilean systemically important banks, the authorities will need to develop a policy and implementation roadmap that is consistent with its wider monetary and financial stability objectives. Chilean authorities will also need to consider how to integrate LAC policy requirements within the wider prudential regulatory and supervisory regime for capital – see Figure 3 below for an illustration of best practice examples of LAC implementation at a national level. LAC policy will also need to define debt eligibility criteria, including specifying minimum maturity profiles of these debt instruments to ensure there are sufficient LAC instruments on the bank's balance sheet to absorb losses through the application of resolution tools by the RA in the event of a future failure.

77. Future LAC policy will need to manage the risk of imposing losses on a failing bank's LAC instrument resulting in contagion to other banks. In addition to having a clear and transparent LAC policy framework that enables banks to risk manage any such exposures, this can be achieved by establishing a LAC deductions requirement for cross-holdings of LAC instruments by other banks. Such a deductions regime is similar to that which already exists for Basel III regulatory capital instrument with respect to cross-holdings of other bank capital instruments. In practice, such a deductions regime would amount to a prohibition on banks from holding each other's LAC instruments by removing all economic incentives to hold LAC instruments.

78. LAC policy will also need to ensure that there is a clear LAC market disclosure requirement on banks similar to the Basel Pillar 3 disclosures requirements for regulatory capital. These disclosures will enable market investors, including domestic pension funds, to risk manage their credit exposures to Chilean bank LAC instruments and set limits on their holdings of LAC debt that reflect their risk tolerance for losses on those investments should a bank fail.

[25] Pension fund industry portfolios are over 14 percent bank bonds (c2 percent in subordinated debt and c12 percent in senior unsecured debt) at end 2020.

Figure 3. Illustration of LAC Requirements (based on RWAs) for a Bank



[1] This illustration does not include the Pillar 2B buffer, which would be set off against the regulatory capital buffer.
[2] The CCB is the capital conservation buffer; the CCyB is the countercyclical capital buffer; and the HLA requirement is the higher loss absorbency requirement applicable to D-SIBs.
[3] Subject to eligibility criteria.
[4] In this illustration, the bank's binding regulatory capital requirements are based on RWAs. In practice, they could be based on its exposure measure.

79. Transitioning the liability structure of banks in Chile and building up sufficient LAC eligible instruments to comply with a future LAC requirement may likely require multi-year transition periods. However, banks in other jurisdictions have been able to build up LAC eligible capital and senior unsecured debt instruments over time through the refinancing of existing wholesale debt at maturity. This can be supported by the appropriate authorities setting transition flight paths to compliance deadlines that are tailored to the funding profile of banks in Chile. As mentioned above, given the existing active participation of the largest Chilean banks in wholesale debt funding markets, this will enable them to buildup LAC eligible as their existing bond funding is refinanced at maturity.

80. As banks issue LAC eligible instruments over time, the authorities will need to be mindful of the contagion risk related to the concentration of LAC debt holding in certain sensitive investor classes that may not be well suited to absorbing losses in the event of a bank failure. The Chilean banking sector's reliance on the pension fund and mutual funds industry as a source of debt funding will need to be carefully managed as banks transition their funding structure to comply with LAC requirements in the future. This may mean banks will need to develop their international investors based for LAC debt more actively. Equally, pension regulators and pension funds will need to ensure that the appropriate risk management frameworks are in place to minimize concentration risk in a bank's LAC debt instruments. The LAC disclosure requirements on banks similar to those already in place under Basel III Pillar 3 disclosures for capital adequacy will inform such investor risk management strategies.

DEPOSITOR PROTECTION ARRANGEMENTS

81. Under articles 144 to 153 of the General Banking Law, the Chilean State guarantees term deposits of natural persons.[26] This guarantee benefits individuals only and covers 90 percent of the obligations that the financial system has contracted with an individual. The coverage has a ceiling of up to UF 200 (about US$8,000) per Bank per calendar year and UF 400 for the system. Acceptance of this guarantee implies renouncing the remaining insolvency receivables to which individuals might typically be entitled. The system is not pre-funded.

82. The BCCh also has an unlimited legal guarantee of sight deposits, and other obligations received or contracted by a banking enterprise (See articles 65 and 132 of the GBL, article 36 N° 2 of the BCCh Law). Sight deposits and obligations are those whose payment may be legally demanded in an unconditional manner immediately. In very limited circumstances where the depositor or creditor is another banking enterprise, the sight deposits, loans or obligations are deemed as time obligations.

83. The current State and BCCh deposit guarantee arrangements in Chilean applies to all banks—domestic and foreign—and has no direct levy cost to those entities whose commercial deposit-taking activities are benefiting from a state or central bank guarantee. The guarantees cover all banks authorized to operate in the domestic market, including branches of foreign banks.

84. The expectation is that the guarantees are paid out by the liquidator during "forced liquidation". The funding for the state guarantee is allocated in the budget every year as contingent. For the BCCh legal guarantee, banks are required to hold a technical reserve in the central bank or Treasury securities and in current accounts or deposits at the BCCh against sight deposits in excess of 2.5 times their own funds or equity capital (or in excess of 1.5 times regarding systemic banks, if such requirement has been applied, article 66 quarter GBL). Importantly, if the funds of the institution under liquidation are insufficient, the central bank has a "super preference" for sight deposits paid under its guarantee in the liquidation (See articles 65, 66 quarter, letter c); 132 GBL). The central bank would finance the payout under the guarantee either by asset purchase or a loan to the liquidator. Such a central bank loan would have the highest credit priority hierarchy during the liquidation process.

85. This report recommends that the institutional arrangements for the financial safety net and deposit protection in Chile be reconsidered in line with best international practices. The current BCCh sight deposit guarantee serves the double purpose of protecting the payment system while at the same time protecting some depositors. However, it is widely recognized that deposit guarantee arrangements should be capped and industry funded. Instead, the role of the BCCh in providing protection for, and ensuring the continuity of, sight deposits as a critical aspect of the Chilean payment system would be better addressed by the adoption of an effective resolution

[26] Law 18,576 that modified the General Banking Law (November 1986).

framework that reduces moral hazard and the creation of a deposit insurance scheme with an ex-ante industry funding model.

86. This report recommends that a new industry-funded deposit protection scheme (DPS) is established, as the new resolution regime comes into force, with the resources and capabilities to implement a rapid payout of covered depositors when failed non-systemically important banks are determined by the resolution authority to enter liquidation. Transitioning to an industry funded DPS will limit the moral hazard and central bank balance sheet risks associated with the current unlimited guarantee of term deposits of natural persons by the State and sight deposits by the BCCh. For example, the World Bank estimated that in 2017 the domestic bank demand, time and saving deposits as a share of GDP was over 50 percent.[27] The DPS should be implemented as the new resolution regime is established and have the resources and capabilities to implement a rapid payout of covered depositors when failed non-systemically important banks are determined by the resolution authority to enter liquidation.

87. A future DPS could be (1) prefunded via an industry levy or premium, or (2) ex-post funded via a levy on industry to recoup any losses incurred on temporary liquidity provided by the central bank or the MoF if such lending was indemnified. An ex-post levy would represent a small step towards insuring the BCCh/State against losses under their sight/term deposit guarantee—however, such ex-post levies can be procyclical. An ex-ante levy would be a more significant reform as it would have a higher up-front cost for Chilean banks who would be responsible for making the contributions to the DPS fund via a new levy.

88. A prefunded premium based DPS fund would better insulate the industry from contagion effects of payouts and the subsequent industry levies in the event of a future non-systemic bank failure. A prefunded premium based DPS fund would also better ensure market confidence in a crisis (i.e., minimize the risk of deposit runs) by ensuring there are sufficient resources to fund an orderly payout. As per the International Association of Deposit Insurers (IADI) core principle 9, a prefunded DPS fund would better insulate the industry from contagion effects related to DPS levies to cover any losses incurred during a future non-systemic bank failure. Such a pre-funded premium based DPS would also reduce the expectation of State support and also can be better tailored to the risks in the deposit system and the level of deposit insurance.

89. The implementation of such DPS reforms and the retirement of the State/BCCh guarantees would also present an opportunity to review the MoF levy on commercial banks, which flow to the general revenue and the BCCh sight deposit technical reserve requirements. The CMF derives its financial resources from a levy on commercial banks. This levy is divided equally between the budget of the CMF, which must be approved by the MoF, and the MoF itself for general revenue purposes. The establishment of an effective DPS would, in effect, act as a substitute to the State's guarantees. As a result, with the establishment of a DPS, the part of the existing levy flowing to MoF could be used, in part or in full, to increase funding to the supervisor's financial

[27] Source: World Bank, Bank Deposits to GDP for Chile, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DDOI02CLA156NWDB, November 10, 2021.

stability work, the new operations of the resolution authority or contribute to an industry levy to prefund a future DPS, thereby ensuring their long-term financial autonomy. Any changes to levy arrangement impacting resourcing for the prudential supervisor should be consistent with Basel Core Principle 2, which requires the financing of supervisors to be structured in a manner that does not undermine its autonomy or operational independence. Equally, a resolution regime for systemically important banks that sets a LAC requirement to ensure public funds are protected may also further weaken the rationale for the existing MoF levy on banks, which is used for general revenue purposes.

90. The establishment of a credible resolution regime and premium-based DPS in Chile may also weaken the rationale for the BCCh technical reserve requirement on banks once the existing guarantee arrangements are retired. Therefore, while recognizing that the recommendation to establish a resolution regime or new pre-funded premium based DPS on the industry are not without costs, they also provide an opportunity to reduce other costs to the sector in the form of the MoF levy and BCCh technical reserve requirement once implemented and operational. The phasing out existing State/BCCh guarantee arrangements will require a credible transitional plan to avoid destabilizing bank funding during the transition.

91. The new industry-funded DPS should also have the authority to help fund the orderly use of resolution tools, including via the transfer in resolution of protected deposits backed by the assets of non-systemically important banks instead of funding the payout of protected deposits in liquidation. Such use of DPS funds should be subject to appropriate limits or caps. Any DPS funds used to support a resolution transfer should not be greater than the losses the DPS would have expected to incur if it had implemented a payout and made recoveries from the winding up of the institution.

92. On institutional arrangements for the new DPS, like the discussion on the designation of the resolution authority above, there is no single model. Instead, the DPS institutional arrangements should be a matter of public policy choice taking into account the distribution of existing financial safety functions among the Chilean authorities. There are a range of options for structuring the DPS, including operating it as an autonomous agency or alternatively under the control of another institution (e.g., the prudential regulatory given the DPS imposes premiums on banks). However, given the continuum between resolution and liquidation described in Figure 1 above, the role of the resolution in determining which banks should enter liquidation and a payout under the DPS, and the potential for DPS funds to be used to help support transfers of protected depositors in resolution, there is a case to be considered for the new resolution authority to be responsible for the DPS.

93. To facilitate a rapid DPS payout protected depositors in the event of a future liquidation, it will be important for non-systemically important banks to be able to identify each unique deposit accountholder, report any covered or uncovered deposit balances depending on future DPS coverage levels, and develop and implement a Single Customer View (SCV) electronic reporting capability. An SCV file is a single, consistent view of a depositor's aggregate eligible depositors with a *firm* that contains the information needed to facilitate a payout.[28] An SCV file requirement also makes the Board and senior management of a bank responsible for ensuring that appropriate policies and procedures are in place to ensure the integrity of the operations, internal controls and relevant depositor information. Banks should be required to demonstrate that relevant systems and processes on which the production of an accurate SCV file depend are operationally robust. Firms are typically expected to be able to provide an update to date SCV file within 24 hours of being requested by the authorities.

CRISIS MANAGEMENT STAFF LEGAL PROTECTION

94. It is important for employees of national regulatory authorities (supervisory, resolution and central bank) to be able to discharge their statutory duties and exercise their professional judgment in doing so, without the threat of lawsuits by banks, their creditors, or other private actions against their actions. In the context of financial crisis management, legal liability may occur when (i) the supervisory authority fails to take any action notwithstanding the knowledge of serious problems in the bank, (ii) measures were inadequate in response to the problems, or (iii) a shareholder of a bank challenges the appointment of a provisional administrator or (iv) a resolution action which interferes with the private property risks in the public interest. However, given the distributional implications of authority crisis management actions and the inventive of various private actions to make every effort to challenge them in court to avoid incurring any losses, it is important that liability accrues only in the event of gross negligence or willful misconduct on the part of the supervisory agency, central bank and resolution agency, or its employees.

95. Under current arrangements in Chile, CMF staff legal protections for officials covers only defense and trial costs. The same protections are afforded to the provisional administrator, the delegated inspector, and the liquidator established in Articles 117 and 130 of the General Banking Act. This defense to these staff even after they no longer hold their position in the CMF. Similarly, for the MoF, any lawsuits against the minister, the State Defense Council's (CDE) President and the Treasury is responsible for the trial costs.

96. It is recommended that statutory clarity should be provided to potential plaintiffs that a case would have no chance of success unless it is based on criminal activity, gross negligence, or bad faith. Moreover, if employees face personal action and have to defend the proceedings, they should have access to resources for actually defending the proceedings, including having an indemnity for costs.

97. Such changes could be made by making an amendment to the GBL to include a provision of indemnity—from personal and institutional liability—for all acts taken by the employee in good faith and in the discharge of duties under the relevant laws. Instead, gross negligence should be required as the threshold to the civil liability of the CMF and BCCh authorities or employees and persons appointed by the CMF, such as inspectors or provisional liquidators.

[28] A SCV file can include Unique customer identifier, name, address, bank account details, recent transaction history, currency split, aggregate balance and compensation due.

These legal protections should also extend to acts or omissions taken in support of foreign resolution measures.

Annex I. Chile Financial System Structure

Table A.1. Chile: Financial System Structure

	No of institutions	Total Assets			
	2020	end-2011		end-2020	
		(billion USD)	(in percent)	(billion USD)	(in percent)
Banks	18	242.2	51%	454.3	54%
Domestic	8	111.7	46%	192.5	42%
Foreign banks	9	90.5	37%	187.1	41%
Subsidiaries	5	89.5	37%	185.3	41%
Branches	4	1.0	0%	1.8	0%
State-owned	1	40.0	17%	74.7	16%
Insurance companies	69	44.8	9%	76.7	9%
Life insurance companies	35	3.2	7%	8.5	11%
Non-life insurance companies	34	41.6	93%	68.2	89%
Pension fund administrators (1)	8	158.1	33%	209.5	25%
Other fund administrators	68	31.4	7%	105.0	12%
Mutual funds	19	24.6	78%	72.2	69%
Investment Funds	49	6.8	22%	32.8	31%
Total	**163**	**476.5**	**100%**	**845.5**	**100%**
GDP (nominal)		**234.0**		**281.9**	
Financial Sector as % of GDP		204%		300%	

Notes: (1) Data from pension funds is as of December 2012

Source: Central Bank of Chile, Superintendencia de Pensiones and CMF.

Table A.2. Top 10 Banks – Dec 2020

BANK	Total assets (USD billion) 2020	(% of total banking)	(% growth 2011–20)
Banco de Crédito e Inversiones	80.4	17.7%	253%
Banco Santander-Chile	78.4	17.3%	126%
Banco del Estado de Chile	74.7	16.4%	154%
Banco de Chile	64.8	14.3%	112%
Scotiabank Chile	51.7	11.4%	537%
Itaú Corpbanca	50.2	11.0%	702%
Banco Bice	12.9	2.8%	157%
Banco Security	11.4	2.5%	107%
Banco Consorcio	8.3	1.8%	660%
Banco Falabella	8.2	1.8%	364%
Top 5 total	**350.0**	**77%**	**179%**
Top 10 total	**440.9**	**97%**	**204%**
National totals	**454.3**	**100%**	**156%**

Source: CMF.

Annex II. Chile 2011 FSAP Resolution Recommendations

	Recommendations	Priority*	Timeframe**	Current Status
1	Strengthen legal framework for bank resolution	H	M	Not implemented. There is no statutory resolution process in Chile. While robust prudential powers are available to improve the resilience of firms in stress, liquidation remains the only tool available when a firm becomes insolvent
2	Consider introduction of a premium-based limited deposit insurance system	M	M	Not implemented. There is a State guarantee for bank time deposits held by natural persons up to a limit of about US$ 8,000 and a BCCh guarantee of 100% of bank sight deposits
3	Examine options to establish a framework for dealing with a systemic crisis and with the potential failure of a financial conglomerate	M	M	Not implemented. CMF is exploring options to establish a recovery planning requirement on banks and how existing powers can be used to support a solvent wind-down of a failing bank

* H/M: High or medium priority.
** S/M: suggested timetable for implementation (short or medium-term).

Annex III. Statutory Resolution Regimes: Comparison of U.K. and U.S.

	The U.K.[1]	The U.S.[2]
Objective	The objective of the Special Resolution Regime (SRR) is to: maintain financial stability, protect confidence in the banking sector, protect depositors, protect public funds.	The Orderly Resolution Authority aims to resolve failing financial companies that pose a significant risk to financial stability in a manner that mitigates such risk and minimizes moral hazard.
Trigger	The regime is triggered when both of the following are met: (1) a bank is failing or is likely to fail; (2) it is unlikely that action will be taken by or in respect of the bank that would allow it to regain threshold conditions.	The company is in danger of default, no viable private sector solution is in sight, and failure would have severe adverse effects on U.S. financial stability.
Creditor Safeguards	"No creditor worse off" ensuring that no creditor of a resolved bank is left worse off than they would have, had the bank been liquidated (s.60); compensation orders for the use of an SRR tool based on independent valuation (s.49-62); set- off and netting arrangements largely respected (s.48).	Set-off and netting arrangements respected (s.210 (a)(11)); equitable treatment of similarly situated creditors in the transfer of assets and liabilities (s.211 (h) (5) (E)); "no creditor worse off" (s.211 (h)(5)(E)(ii)).
Flexible tools	The authorities can use the following tools: write-down or convert bank creditors (i.e., bail-in), share transfer, asset and liability transfer (to private sector purchaser or temporary bridge bank owned and controlled by the Bank of England), temporary public ownership (TPO), and modified bank insolvency procedure.	Traditionally: purchase and assumption, bridge bank, open bank assistance (a form of TPO), and receivership. Dodd-Frank provides that systemic financial holding companies will be resolved via a bridge bank arrangement.
Liquidity in resolution arrangements	BoE Resolution Liquidity Framework[3] , which provides the tools to lend to banks subject to the resolution regime secured against a wide range of collateral, building on the collateral eligible in Sterling Monetary Framework operations; Possible use of resources from the Financial Services Compensation Scheme (FSCS).	Resolution is funded from an Orderly Resolution Fund (funded from ex-ante contributions from systemic firms) supplemented by borrowing from Treasury (subsequently repaid from industry contributions).

[1] U.K. Banking Act 2009.

[2] U.S. Dodd-Frank Act 2010.

[3] See Box 2 in "*The Bank of England's approach to resolution*" October 2017 – link

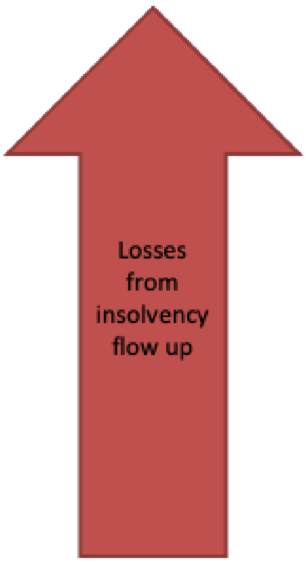
	With HMT consent, public funds can be used from the Consolidated Fund to fund a resolution, providing financial assistance to a bank, another financial institution or the Bank of England.	
Financial Groups	The U.K. resolution regime applies to banks, building societies and certain investment firms and their financial holding companies that are incorporated in the United Kingdom, including U.K. subsidiaries and branches of foreign firms. CPPs are also in the scope of the regime.	Dodd-Frank provides that where a financial holding company is deemed systemic, the group will be resolved by FDIC in its entirety.

Annex IV. Defining Supervisory and Resolution Authority Responsibilities

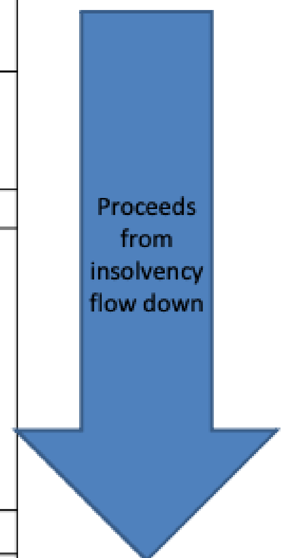
The following table describes at a high level the primary roles and responsibilities of the supervisory authority as distinct from those of the resolution authority.

Authority	**Roles and responsibilities**
Supervisory authority	Going concern prudential supervisory actions, including: 1. Assessment of capital and liquidity risk 2. Assessment of risk management 3. Assessments of Governance arrangements and key personnel 4. Power to require banks to develop recovery plans and implement this in response to stress
Shared responsibility between supervisory and resolution authority	Assessment of whether a bank is failing or likely to fail has two aspects – solvency and viability: • Solvency - Supervisory authority to assess the first condition of whether a firm is solvent or is judged to be failing or likely to fail • Viability - Resolution authority to assess whether the second condition for resolution is met, i.e., whether there is a reasonable prospect of the firm recovering and being able to meet its conditions for authorization within a reasonable timeframe If both conditions are judged to be met by the respective authority, then the resolution authority can take the firm into the resolution regime as necessary to minimize resolution costs or preserve financial stability
Resolution Authority	Pre-resolution actions 1. require information for resolution planning; 2. set a preferred resolution strategy for banks, e.g., bail-in etc. 3. asses firm resolvability under the preferred strategy, i.e., identify barriers to orderly failure via the resolution regime; 4. requiring the removal of barriers to resolvability, e.g., to make changes to legal, operational and financial structure necessary to ensure orderly resolution; 5. setting firm-specific loss absorbency requirements (if required by the preferred resolution strategy); Resolution actions 1. exercise the write-down or conversion into equity of regulatory capital at the point of non-viability (PONV) 2. implement resolution actions or powers, e.g., share or asset/liability transfer powers, bail-in etc.

Annex V. Bank Creditor Hierarchy in Insolvency*



Order of priority
Fixed charge holders (mortgage, pledge, lien), including: • Capital market transactions (e.g. covered bonds) • Trading book creditors (e.g. collateralised positions)
Liquidators (fees and expenses)
Super-preferred creditor: • eligible depositors for the amount up to protected balances • Employees with labour-related claims
Preferred creditors, including: • Depositors that are individuals and micro, small or medium-sized businesses for amounts in excess of protected balances
Floating charge** holders (i.e. debentures)
Unsecured senior creditors, including • Bondholders • Trading book creditors • Creditors with master netting agreements (net position only) • Trade creditors • Depositors that are <u>not</u> individuals or micro, small and medium-sized businesses for amounts in excess protected balances
Unsecured subordinated creditors
Interest incurred on subordinated unsecured debt post insolvency
Shareholders (preference shares)
Shareholders (ordinary shares)



* Proceeds recovered through insolvency are used to meet the claims of creditors in the top row first, with any excess being passed down to meet claims of creditors in the second row, and so on. Any losses arising from a shortfall between proceeds and creditor claims are incurred firstly by shareholders and then passed up the creditor hierarchy until they are fully absorbed. Creditors within a row are treated equally (rank 'pari passu').

** Floating charges that constitute financial collateral arrangements or collateral security can rank senior to preferential creditors and liquidators' fees and expenses.