

### 3.8 CHILE

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#### I. FRAMEWORK

The legal framework for Chilean covered bonds (*Bonos Hipotecarios*, also BHs) is determined by:

- > The General Banking Law (Ley General de Bancos, LGB): Article 69, n°2, BH issuances; and Articles 125, 126 and 134, special treatment of banking entities under bankruptcy.
- > The Chilean Central Bank: Financial Regulation Compendium (*Compendio de Normas Financieras*, CNF), Chapter II.A.2, Chilean Central Bank complementary rules.
- > Superintendency of Banks (*Superintendencia de Bancos e Instituciones Financieras*, SBIF): *Recopilación Actualizada de Normas* (RAN), Chapter 9-2, Complementary rules of the Chilean banking regulatory agency.

In 2010, Law 20.448 – also called MKIII, the third reform to the Capital Markets Law – introduced a series of changes in terms of liquidity, financial innovation and integration of the capital markets. Among them was the amendment of Article 69, n°2 of the LGB which enabled banks to issue bonds with no special guarantees, called BHs. These securities are specifically aimed to raise funds for the origination of mortgage loans (*mutuos hipotecarios*) used to finance the acquisition, construction, reparation or extension of residential properties. Only residential mortgages for these purposes are accepted as collateral, excluding commercial, public or other types of loans. An additional restriction imposed to define an eligible mortgage is that only new mortgages are accepted. Hence, a maximum time limit of 18 months was set for the origination of eligible loans since the date of the BH's issuance. Thus, BH bonds also have an anticipated rescue clause for a proportional prepayment of the bond in case of insufficient origination. The issuer has the flexibility of an additional one-month period to incorporate new mortgage loans of the same nature and quality to comply with the cover asset limit and balance principle at the end of this 18 months allocation period and at the end of each month along the life of the bond.

Under an eventual credit event/default of an issuer, Articles 125, 126 and 134 of the LGB give BHs the same treatment and current legal status as that of outstanding *Letras Hipotecarias* (LH), a type of mortgage bond frequently used by Chilean banks in the past to finance their mortgage business. These articles regulate the procedures in such case and the mechanisms for the tender process and subsequent transference of eligible loans/assets and liabilities from the defaulted issuer to a new entity.

In September 2012, the final regulation was published in a joint statement by the Chilean Central Bank and the SBIF, describing BHs as a new source of long term funding for banking entities, thus allowing better conditions for clients as well as a new investment alternative for institutional investors. At the same time, it explicitly incorporated a prudential regulation associated with financial stability objectives. In particular, it stated the obligation of periodic reporting of both bonds and loans, the definition of certain credit indicator limits, specific policies to grant loans and other transparency objectives for the benefit of both clients and investors.

Chapter II.A.2 of the CNF regulates issues related with eligible loans, as well as investments in fixed income securities as substitute collateral since the date of issuance during the period of loan origination, specifying limits for compliance during the whole life of the bond.

The SBIF's RAN mainly regulates the issuance of BHs, the relationship between bonds and loans, and the establishment of a special Register for further control which includes detailed up-to-date information to comply with transparency and monthly reporting objectives.

## II. STRUCTURE OF THE ISSUER

Under current legislation only banking entities are allowed to issue *Bonos Hipotecarios*. Cover assets are held within the balance sheet with the proper internal controls to monitor the cover pool and its relationship with its related bond ratios and limits over time.

Banco Santander Chile issued the first ever local covered bond (Bono Hipotecario). The first covered bond program was for a total amount of UF 3 Million (approx. USD 134 million), the first issuance out of the program was in August 1<sup>st</sup>, 2013 for a total amount of UF 1.5 MM (approx. USD 68 million) and then the second one was in November 20<sup>th</sup>, 2013. Both issuances generated a great appetite from local investors and the result was a spread of 15 bps lower than the senior unsecured debt outstanding. In 2014 Banco Santander Chile successfully registered a second covered bond program for a total amount of UF 5 million and issued an amount of UF 1.5 million in September 2014.

As of 31 December 2017, Santander Chile is still the only active issuer of covered bonds in the Chilean market.

## III. COVER ASSETS

Regulation states that issuers have 18 months since the bond's date of issuance to allocate the resources to the origination of mortgages. After that period, at the end of each month during the life of the BH, the outstanding balance of mortgages, excluding amounts in arrears, should not be lower than 90% of the outstanding balance of the respective bonds. Any difference between the outstanding amounts of the mortgages and the bonds must be covered by high credit quality fixed income instruments.

FIGURE 1: FIXED INCOME SUBSTITUTE COLLATERAL: MINIMUM 80% IN SOVEREIGN BONDS (CATEGORIES: I. AND II.)

<b>I.</b>	Sovereign bonds	Fixed income instruments issued by Chilean Central Bank.
<b>II.</b>	Sovereign bonds	Fixed income instruments issued by Chilean treasury.
<b>III.</b>	Corporate bonds	Local Corporate bonds rated AA+ or higher (by at least two rating agencies). Sub limit of up to 10% of the total of funds by each <i>Bono Hipotecario</i> issuance.
<b>IV.</b>	Bonos Hipotecarios	<i>Bonos Hipotecarios</i> issued by other banking entities.
<b>V.</b>	Term deposits	Term deposits originated by high rated banks established in Chile, excluding those of the issuer of the covered bonds.
<b>VI.</b>	LCH	Housing LH: <i>Letras De Crédito Hipotecario</i> issued for housing purposes by other banking entities.
<b>VII.</b>	Unsecured bank bonds	Unsecured bank bonds rated AA+ or higher (by at least two rating agencies), excluding those of own issuance.

Source: Chilean Central Bank, Banco Santander Chile

## IV. VALUATION AND LTV CRITERIA

Eligible loans are only accepted as collateral for the corresponding issued bond once the accredited third-party property appraiser has finished the valuation process and after it has been registered at the corresponding CBR (*Conservador de Bienes Raíces*) – the local entities that certify legal dominion of properties.

The minimum loan-to-value (LTV) defined by law is 80%. Conditions for valuation are also subject to performing or non-performing status of loans. The maximum accepted number of arrears of any single loan in the pool is 10. Above that, the loan must be replaced with a new one of the same nature. As explained before for the cover-to-bond outstanding balance ratio all amounts in arrears are excluded.

LTV alone is not enough for eligibility of mortgage loans. In addition, a maximum debt-to-income ratio of 25% is demanded.

## **V. ASSET – LIABILITY MANAGEMENT**

Current legislation does not prescribe overcollateralisation for the issuance of BHs.

Under a balance principle the nominal amount of cover assets must always be at least equal to the outstanding amount of related *Bonos Hipotecarios* and loans in arrears or prepaid should be replaced always under the restriction that only new mortgages are potentially eligible as collateral for BHs.

Banks are free to structure the covered bonds according to their own needs and criteria. Banco Santander's first program bond was a 15-year amortising structure reflecting the expected amortisation schedule of the underlying loan portfolio adjusted by the empirical loan prepayment rate. The second registered bond program was an 18-year amortising structure reflecting the expected amortisation schedule and the empirical prepayment rate of the new loan portfolio.

## **VI. TRANSPARENCY**

Current regulation includes a prudential approach associated with financial stability objectives: mandatory monthly reports of assets and liabilities in the Register and compliance of required ratios; a specific Credit Policy for mortgage eligibility which must be approved by the Board of Directors and published on the issuer's webpage; and client's LTV and debt-to-income ratios reported in a monthly basis.

## **VII. COVER POOL MONITOR AND BANKING SUPERVISION**

Article 69, n°2 of the LGB mandates banks to maintain a special mortgage register (*Registro de Mutuos Hipotecarios*) for the identification and control of the relation between mortgages and their respective BH issuances.

SBIF's RAN 9.2, n°5, sets conditions for inscription of mortgages on the Register and the required information including: identification of bond issuance and loans; dates of inscriptions; original and substitute loans; identification of fixed income assets held as substitute collateral; and elimination from the register by number of arrears or property value deterioration.

Central Bank's CNF Chapter II.A.2, n°18, within its explicit transparency and information objectives, details monthly reporting data including: up-to-date average debt-to-income ratios of clients with eligible loans for each series of BH issuances; average value of properties linked to BHs at the date the credit was granted; LTV of the pool updated by loan replacements; loan characteristics (maturity, interest rates, fixed, floating or mixed type, currency denomination, inflation link mechanism and loan prepayment conditions); outstanding balances of loan portfolios and associated BH issuances and, finally, the total amount of fixed income assets and its general characteristics.

## **VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS**

There are 2 main issues related with bankruptcy in the BH legislation:

- 1) Since only new loans are accepted as collateral, this avoids the possibility of structuring BHs with a selection of the best quality assets which could be against the interests of other creditors such as depositors in case of bankruptcy.
- 2) In the case of bankruptcy, a special procedure in the way of a separated auction or tender process is triggered for those assets and liabilities clearly identified and associated with BHs in the Register. Eligible bidders are other public or private financial institutions, and the final buyer must take care of BH payments. This process is thoroughly covered in the LGB, same as for Letras de Crédito Hipotecarias (LH).

## **IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION**

Chile is not a member of the European Union. Therefore, Chilean BHs are issued under the existence of a specific country legislation – which is a requirement for these matters – no special treatment or benefit is granted in terms of preferred risk-weighting for regulatory capital purposes.

## **X. ADDITIONAL INFORMATION**

In a clear intent to provide these Bonds with more liquidity the Chilean Central Bank announced on the 28 March 2013 a special Repo program (“Repo BH”) which accepts exclusively BHs as collateral. The Repo BH is offered for up to 14 days at a floating rate equivalent to the current monetary policy rate (MPR) of each day plus 25 basis points. Eligible BHs will be subject to the credit rating of the BH issuer banking entity which must be in AAA, AA or A.

On top of this, on July 2015 the SBIF announced a change in the regulation for Liquidity Management. This amendment introduces the compulsory measurement and reporting of the Liquidity Coverage Ratio and the Net Stable Funding Ratio. This local LCR ratio recognises BHs as high quality liquid assets, which could promote the appetite of financial institutions for this asset class.

On an additional attempt to promote the issuance of this type of instruments, the SBIF announced on the 31 January 2017 an amendment on Chapter 9-2, n°5.1 of the RAN, allowing mortgage loans issued before the bond’s date of issuance to be eligible for the cover pool as long as they were granted after the beginning of the interest accrual period stated in the amortisation schedule of such bond and after the registration certificate of such bond is published by the issuer in its website. The main objective of this amendment is to make the cover pool easier to build in the 18-month time limit after the date of issuance of the BH.

Despite these incentives, there have not been BHs issuances in the Chilean market other than the ones placed by Santander Chile. This lack of activity can be explained by the fact that the more relevant Chilean issuers already have the maximum credit risk rating (AAA), and therefore the double recourse guarantee provided by the BHs is currently not as valuable for the potential investors, specifically for banks, given that it does not provide an advantage in terms of capital consumption compared to standard corporate bonds.

**ECBC Covered Bond Comparative Database:** [http://www.ecbc.eu/framework/113/Chilean\\_Covered\\_Bonds](http://www.ecbc.eu/framework/113/Chilean_Covered_Bonds).