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# ECUADOR

## FINANCIAL SECTOR ASSESSMENT

September 2023

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A joint IMF and World Bank team conducted virtual and in-person missions to Ecuador in December 2022 and April 2023 to update the findings of the Financial Sector Assessment Program (FSAP) conducted in 2004.[1] This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities and developmental issues, and provides policy recommendations.

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# GLOSSARY

| | |
|---|---|
| AML/CFT | Anti-Money Laundering/Combating the Financing of Terrorism |
| AQR | Asset Quality Review |
| ATM | Automatic Teller Machine |
| BCBS | Basel Committee on Banking Supervision |
| BCE | *Banco Central del Ecuador* (Central Bank of Ecuador) |
| BCP | Basel Core Principles for Effective Banking Supervision |
| BIESS | *Banco del Instituto Ecuatoriano de la Seguridad Social* (Bank of the Ecuadorian Institute of Social Security) |
| CAR | Capital Adequacy Ratio |
| CFN | *Corporacion Financiera Nacional* (National Finance Corporation) |
| CONALAFT | *Comité Nacional de Coordinación Contra el Lavado de Activos, el Financiamiento del Terrorismo y la Proliferación de Armas de Destrucción Masiva* |
| COSEDE | *Corporación del Seguro de Depósitos* (Deposit Insurance Corporation) |
| COVID | Coronavirus Disease |
| CPMI | Committee on Payments and Market Infrastructures |
| CSD-SSSs | Central securities depositories and securities settlement systems |
| DAR | Detailed Assessment Report |
| DBs | Development Banks |
| DNS | Deferred net settlement |
| D-SIBs | Domestic Systemically Important Banks |
| DvP | Delivery versus payment |
| ELA | Emergency Liquidity Assistance |
| ESG | Environmental, Social and Governance |
| FMI | Financial Market Infrastructure |
| FSAP | Financial Sector Assessment Program |
| FSI | Financial Soundness Indicator |
| FX | Foreign Exchange |
| GDP | Gross Domestic Product |
| GHG | Greenhouse Gas |
| IMF | International Monetary Fund |
| IOSCO | International Organization of Securities Commissions |
| JPRF | *Junta de Politica y Regulacion Financiera* (Board of Financial Policy and Regulation) |
| JPRM | *Junta de Politica y Regulacion Monetaria* (Board of Monetary Policy and Regulation) |
| LAC | Latin America and the Caribbean |
| LCR | Liquidity Coverage Ratio |
| MER | Mutual Evaluation Report |
| MSMEs | Micro, Small and Medium Sized Enterprises |
| MoU | Memorandum of Understanding |
| NBFI | Non-Bank Financial Institution |
| NDC | Nationally Determined Contribution |
| NFIS | National Financial inclusion Strategy |
| NGFS | Network of Central Banks and Supervisors for Greening the Financial System |
| NPL | Nonperforming Loans |
| POS | Point of Sale |
| QR | Quick Response |

| | |
|---|---|
| PFMI | Principles for Financial Market Infrastructures |
| RoA | Return on Assets |
| RoE | Return on Equity |
| RTGS | Real-time gross settlement |
| RWA | Risk Weighted Asset |
| SARAS | *Sistema de Administración de Riesgos Ambientales y Sociales* (Environmental and Social Risk Management System) |
| SB | *Superintendencia de Bancos* (Superintendence of Banks) |
| SCP | *Sistema Central de Pagos* (Central Payment System) |
| SEPS | *Superintendencia de Economia Popular y Solidaria* (Superintendence of Popular and Solidarity Economy) |
| SML | Securities Market Law |
| SOFI | State-owned Financial Institution |
| SPI | *Sistema de Pagos Interbancarios* (Interbank payment system) |
| SPL | *Sistema de Pagos en Línea* (BCE real-time gross settlement system) |
| SSS | Securities Settlement System |
| SVCS | *Superintendencia de Compañías, Valores, y Seguros* (Superintendency of Companies, Securities, and Insurance) |
| UAFE | *Unidad de Análisis Financiero y Económico* (Financial Intelligence Unit) |
| WB | World Bank |
| WEO | World Economic Outlook |

# EXECUTIVE SUMMARY[2]

**The Ecuadorian financial sector has remained stable, but credit growth has slowed since mid-2022, liquidity conditions have tightened, and GDP growth has moderated**. Higher international interest rates and competition for deposits have increased funding costs which, combined with ceilings on lending rates, has led to margin compression for credit providers.

**The institutional framework for financial sector oversight is not functioning as intended, and concrete actions are needed to improve inter-institutional coordination.** The framework is prone to political intervention, oversight and supervisory bodies have resource and capacity constraints, and there is a lack of clarity on roles and mandates, as well as a lack of information-sharing. This constrains the effectiveness of financial stability oversight and holds back financial markets development. In order to improve the functioning of the institutional framework, the division of objectives, functions and powers of each agency should be clarified, cooperation and information sharing agreements should be agreed, data-sharing protocols implemented, and a systematic process to monitor systemic risks and enhance analytical capacity should be initiated. Processes, organizational arrangements, and tools are needed to monitor, assess and mitigate systemic risks (including through the establishment of a Financial Stability Committee). A National Payments Council or similar body should also be created.

**Financial sector supervision needs to be strengthened,** including through the full implementation of the new risk-based supervision framework by the *Superintendencia de Bancos* (SB), and by ensuring that SB and the *Superintendencia de Economia Popular y Solidaria* (SEPS) have the supervisory powers and tools needed. Authorities are committed to strengthen the prudential framework and have several ongoing initiatives in this direction. However, institutional shortcomings, insufficiently trained staff, and lack of coordination impair sound supervision. Closing the large gap between current practices and international standards requires a comprehensive plan including actions to substantially enhance the technical and analytical capacity of financial sector authorities, to set safety and soundness as the primary goal of supervisory agencies, and to remove constraints to their independence and enhance their powers. Greater attention to climate-related risks is also needed.

**Managing liquidity risk is a challenge for Ecuador's financial system, and the lack of a market for government bonds restricts the ability of banks to manage liquidity safely and efficiently**. Requirements for financial institutions to maintain liquid assets in Ecuador (Domestic Liquidity Ratio) and minimum requirements on investments in public securities at non-market prices, facilitate government financing at the expense of risk diversification at the systemic level. While dollarization provides an important anchor for the Ecuadorian economy, liquidity risks are exacerbated by the limited capacity of the central bank, by thin interbank funding markets and by low availability of domestic assets that would comply with international liquidity standards. This also has broader negative impact on domestic financial intermediation. It is then key to establish sound liquidity requirements, remove impediments to banks' investments in global liquid assets, reform the Liquidity

[2] The WB's Financial Sector Assessment (FSA) should be read alongside the IMF's Financial Sector Stability Assessment (FSSA) and the FSAP Update's Technical Notes (TNs).

Fund, and further develop the interbank and securities markets. These reforms will need to be sequenced carefully while addressing ongoing fiscal challenges.

**The state plays a prominent role in the provision of financial services through state-owned financial institutions (SOFIs), yet the lack of comprehensive reporting or evaluation for public credit programs and SOFI interventions makes it difficult to evaluate costs and assess value for money.** Available information on their portfolio quality and efficiency indicators point to substantial inefficiencies and vulnerabilities. Weaknesses of SOFI balance sheets and operations should be addressed based on viability assessments and further asset quality reviews (AQRs), while supervision and enforcement need to be intensified. Corporate governance of SOFIs should be strengthened, as well as the supervisory approach (including for consolidated supervision) to SOFIs. To enhance efficiency and impact, public credit support programs should be redesigned, and expectations of debt forgiveness removed.

**A comprehensive reassessment of the six SOFIs should be carried out in order to lay out a reform agenda with clear policy objectives and operational synergies.** The merger of CFN and Banecuador currently mandated by law does not consider the mismatch in business models between the two institutions nor does it create synergies, thus should be reconsidered and halted. Moreover, CFN should complete its transition to a second-tier lending institution, which has provided positive results in terms of complementarities with the private sector and in terms of the financial health of the institution, while offering the opportunity to evaluate the feasibility of a merger with CONAFIPS, another second-tier lender. Banecuador -a development bank that provides small credits to borrowers without using a microcredit technology and consistently reports losses despite not properly classifying and provisioning assets- needs 'top to bottom' restructuring, which calls for a frank assessment of the value of the institution and potential alternatives to attain the financial inclusion objectives of the institution. While Banco del Pacifico (BdP) should continue to seek privatization, it could explore venturing down-market in a sound fashion to provide a blueprint for other private commercial banks. In line with the pension reform that is being considered by the authorities, the role of *Banco del Instituto Ecuatoriano de la Seguridad Social* (BIESS) as a fund manager should be strengthened and an AQR conducted to inform improvements of credit operations.

**Financial repression through the system of interest rate ceilings distorts capital allocation and undermines risk-based pricing, and analysis by the FSAP team shows that the more binding the interest rate ceilings are, the fewer unbanked borrowers are reached.** Existing ceilings on lending rates should instead be migrated to a usury rate, as they have perverse effects on financial inclusion, resulting in competition for existing rather than new borrowers, and shifting credit away from productive purposes. The transition to market-based interest rates includes elements of price discovery, which can be prompted by the development of liquid money markets, as well as consumer protection regulation to enhance transparency and financial education of the population.

**Given that rate ceilings have not proven to be effective for expanding financial inclusion, the priority for increasing access to finance should instead be on improving financial infrastructure in order to lower the costs and risks of lending.** This would enable both lower interest rates and expanded financial access. A modern credit registry with corresponding legislation to expand and strengthen data collection, aligned with data protection measures, should be developed. A secured transactions framework that supports expanded SME finance, including for the use of transaction data to address information asymmetry and enable digital credit, is needed in parallel. There is also potential for cooperatives to play a more frontier role in reaching unserved firms and individuals. While cooperatives have increased credit provision, in many cases this was done by serving clients that would already be viewed as 'bankable'. Cooperatives could expand access to unbanked clients through their membership structure and regional or community knowledge, and by adopting microcredit technologies.

**The playing field between SOFIs and private credit institutions should be levelled, and financial repression through requiring minimum holdings of government securities and in SOFIs at non-market prices should be addressed.** Remunerating mandatory investments in SOFIs at market rates would be a first step, with their gradual removal assessed. Private credit institutions should also be able to deduct credit payments directly from payrolls and collect debts through coercive trials (*coactiva*). Most SOFIs also enjoy lighter requirements than commercial banks and credit cooperatives, and the level of enforcement of existing requirements by supervisors is also behind that for the private sector. With regard to reducing the potential for 'regulatory arbitrage' between cooperatives and banks, important progress has been made in harmonizing the capital, loan classification and provisions, and liquidity requirements of cooperatives up to par with that of banks.

**The safety, efficiency and inclusiveness of Ecuador's national payments system needs to be enhanced, through strengthening its foundations and risk management.** The migration of high value transactions to real-time gross settlement needs to be expedited, while fast payments initiatives need to converge towards common rules and technical standards. The majority of transactions are processed through a net settlement mechanism with three daily cycles, without fully addressing credit risk and leaving the system vulnerable to unwinding. The rollout of real-time gross settlement, while mitigating credit risk, will pose larger liquidity demands on participants. This raises concerns in the absence of a central bank intraday liquidity facility and an active repo interbank market: the provision of tools and incentives to manage liquidity efficiently will be critical. Furthermore, risk-management governance and oversight of the central bank-operated payment system should be strengthened. The retail payments ecosystem is characterized by vertical integration, limited electronic payments acceptance and interoperability. The development of fast payments represents an opportunity to address these shortfalls, but competing initiatives without a unified approach may fall short of achieving impact. The Central Bank of Ecuador (BCE) should define the scope of its operational role, consistent with the overall reform of the BCE payment system, and strengthen its oversight and catalyst functions. The Fintech Law will usher new entrants into the market, without clear or efficient allocation of authorities' responsibilities for regulation, supervision and oversight. Authorities should consolidate and strengthen the regulatory framework for payment services, including electronic deposits and payment initiation.

**The securities custody, clearing and settlement infrastructure should be enhanced to achieve straight-through processing (STP), increase resilience, and boost market confidence.** This infrastructure comprises the BCE-operated DCV and DECEVALE, owned by the stock exchanges and other shareholders. Both CSD-SSS should strengthen their risk management frameworks and enable STP via a connection with the payment system. BCE and SCVS should develop detailed cooperation protocols for the supervision and oversight of DCV, and adopt international oversight standards and apply them consistently to both CSD-SSS.

**A sequenced approach to develop the nascent domestic capital markets is needed to ensure larger and better allocation of financial savings that would greatly benefit the government, the financial sector, corporates, and the broad economy.** An efficient government debt market would facilitate fiscal space through business cycles; an effective money-market would improve the liquidity of banks bolstering systemic resilience; and enterprises would have an additional source of financing, ultimately contributing to faster economic growth. The lack of critical preconditions for a local bond market to emerge -including recurring debt defaults, macro instability and the lack of a long-term savings industry- has precluded capital markets in Ecuador from developing. Reforms should be approached as a gradual long-term process, with safeguards and transparency in order to avoid distortions. The first step should include measures to provide solid reference risk-free rates and tools for liquidity management, with a focus on the short end of government debt market. The Ministry of Economy and Finance (MEF) should transition to market mechanisms for placement of government securities, which would enable the use of such securities as collateral by banks and other investors to start using repos, laying the foundations for a healthy money market. While SOFIs may contribute to market development, their participation in the repo and secondary markets should not be used by the MEF to manipulate price signals, but rather to facilitate the transition towards a market mechanism.

**Despite Ecuador's exposure to climate and environmental risks the supervisory response is at an early stage and green finance markets are not developed at scale to meet climate funding needs.** Responsibilities for the system-wide monitoring of climate risks need to be clearly assigned, and a top-down exposure assessment performed of vulnerabilities in the banking and cooperative sector. The supervisory response to climate and environmental risks should be strengthened through increased capacity and resources at the superintendencies as well as enhanced inter-agency cooperation. Over time authorities should develop a strategy for expanding the focus of supervisory attention from environmental to climate risk management. Scaling Ecuador's green finance markets to meet its climate and environmental objectives will be challenging and requires enhanced inter-agency coordination, participation from the private sector, harmonized definitions, and legal frameworks for green products as well as a green taxonomy.

### Table 1. Ecuador: 2023 FSAP Key Recommendations

| Recommendation | To be adopted by | Time* | Paragraph |
|---|---|---|---|
| ***Systemic Risk Analysis*** | | | |
| Enhance capitalization, promptly recognize loan losses, and address unviable financial institutions. | SB, SEPS | I | 33, 37 |
| Gradually remove requirements for banks to hold liquid assets domestically. | MEF, JPRF, JPRM | NT | 28 |
| ***Financial Sector Oversight*** | | | |
| Develop processes, organizational arrangements, and tools to monitor, assess and mitigate systemic and climate risks. Perform a top-down exposure assessment of the banking and cooperative sectors' vulnerabilities to climate events. | MEF, JPRF, JPRM SB, SEPS, BCE | I | 21, 28 |
| Enhance technical and analytical capacity of supervisory agencies by establishing a career plan, sound training program, and adequate resources. | SB, SEPS, MEF, UAFE, CONALAFT | I | 30 |
| Clarify responsibilities, functions, and powers of different agencies, and consider the establishment of a Financial Stability Committee and a National Payments Council. Use cooperation and data-sharing protocols/arrangements between financial sector authorities. | MEF, JPRF, JPRM, SB, SEPS, SCVS, BCE | NT | 25, 28 |
| Implement Basel III buffers (conservation, countercyclical, D-SIB), liquidity requirements and borrower-based measures. | MEF, JPRF, SB, SEPS | NT | 28 |
| Strengthen the supervisory approach, consolidated supervision, and corporate governance requirements and ensure convergence of supervisory and regulatory standards for large cooperatives and both public and private banks. | SB, SEPS, JPRF | NT | 31, 36 |
| Strengthen the institutional framework for supervision by making safety and soundness the primary goal of the superintendencies and enhancing their independence. | MEF, SB, SEPS | MT | 30 |
| ***Role of the State*** | | | |
| Migrate interest rate ceilings to a usury rate and in the transition revise definitions for credit segments. | JPRF | I | 55 |
| Address vulnerabilities in SOFIs: (i) fully recognize loan losses and implement AQR provisioning recommendations; (ii) enhance corporate governance, internal controls and risk management capacity; (iii) Intensify prudential supervision and enforcement over SOFIs. | MEF, SB, IESS | I | 47, 48, 51 |
| SOFI reform: (i) reassess CFN-Banecuador merger, incorporate wholesale business model for CFN in legislation, create an asset management company inside CFN and evaluate the feasibility of a CFN-CONAFIPS merger; (ii) Assess value of Banecuador operations and consider potential alternatives that support wind down operations, including down-market expansion by BdP; (iii) Revise BIESS mandate, strengthen role as a fund manager and conduct an AQR to inform improvements of credit operations; | National Assembly, MEF | I/NT | 51, 52, 53 |
| Increase effectiveness of public credit support programs: (i) Monitor and disclose aggregated amount of subsidized credit; (ii) Implement a strategy to evaluate impact of programs and policies; (iii) Redesign programs to provide repayment incentives and ensure private sector participation; (iv) Remove expectations of debt forgiveness and develop catastrophic insurance strategy. | MEF, JPRF, SB | NT | 49 |
| Level the playing field between SOFIs and private credit institutions: (i) Remunerate mandatory investments in SOFIs at market rates and assess their gradual removal; (ii) Enable private credit institutions to deduct credit payments directly from pay rolls and collect debts through "coativa" process. | JPRF, Congress | NT | 50 |
| ***Access to finance for SMEs*** | | | |
| Adoption and implementation of the National Financial Inclusion Strategy (NFIS), including through effective institutional coordination | JPRF | I | 63 |

| | | | |
|---|---|---|---|
| Address gaps in cooperatives credit methodologies and risk management practices, ensure that cost of credit is disclosed in a transparent manner. | SEPS, SB | NT | |
| Improve credit information by granting access to the credit registry data to SEPS, enabling expanded alternative data collection, strengthening collaboration among regulatory and supervisory authorities and encouraging participation of additional data providers. | JPRF, SB, SEPS | NT/MT | 64 |
| Develop alternative products for SMEs: (i) Develop the legal and regulatory framework for secured transactions to promote new products relying on movable collateral and promote the rollout of an online collateral registry; (ii) Expand cloud-based accounting, which could be linked to e-invoicing. | JPRF, MEF, Ministry of Production (MoP) | MT | 65 |
| Overhaul legal regime for insolvency, include streamlined insolvency regime for micro and small firms. | MEF, MoP | MT | 66 |
| ***Payments and financial market infrastructure*** | | | |
| Expedite the migration of high-value transactions to the new RTGS system, including the settlement of the cash leg of securities transactions, and evaluate liquidity management tools. | BCE | I | 71 |
| Upgrade DCV to ensure straight-through-processing, integrate DCV with the payment system and strengthen risk management and governance. Measure, mitigate and manage general business risk at DECEVALE, develop plans for an orderly wind down. | BCE, JPRM, DECEVALE | I | 72, App. II |
| Foster convergence of fast payment initiatives towards common rules and technical standards, determine scope of BCE’s operational role. | BCE, JPRM | I | 73 |
| Ensure a strong legal basis for all material aspects of FMI operations and the NPS as a whole, adopt the PFMI. | JPRM, Congress | NT | 69 |
| Consolidate and strengthen the legal and regulatory framework for payment services and fintech, including on electronic deposits and payment initiation | JPRM, JPRF, Congress | MT | 74 |
| ***Capital Markets Development*** | | | |
| Streamline the supply of government securities, build the necessary arrangements to transition to regular auctions with MEF as price-taker with discount instruments. | MEF | I | App. II |
| Review processes for approval of issuances, improve the assessment of credit risk and enhance regulation and oversight of corporate debt issues including rating agencies. Assess regulation and capital requirements of the custodians. | SCVS, JPRF | I | App. II |
| Plan exchanges with SOFIs and other bond holders to facilitate the organization of maturities. Promote the participation of SOFIs in the repo and secondary markets and consider legal and regulatory reforms for BCE or stock exchanges to launch a centralized trading venue for repos with government securities. Intensify efforts to develop an interbank money market, including by leveraging DCV. | National Assembly, MEF, BCE, JPRM, JPRF, SB, SCVS, BVQ, BVG | NT | App. II |
| Broaden the investor base allowing nonresidents to participate in the capital market, as well as by refocusing BIESS mandate on managing the social security funds. | JPRF, MEF, SCVS, SB | MT | App. II |
| Remove restrictions in the SML for banks and cooperatives to issue Commercial Paper. Boost the supply of corporate securities by revising SCVS approval process. | National Assembly, JPRF, JPRF, SCVS | MT | App. II |
| ***Green Finance*** | | | |
| Finalize the legal and regulatory frameworks for thematic bonds | SCVS, JPRF, MEF | I | 83 |
| Set up a national platform on green finance with participation of the superintendencies, MAATE, MEF as well as relevant private sector stakeholders to coordinate and advance development of green financial markets | SB, SEPS, SCVS, MAATE, MEF, Asobanca | NT | 82 |
| Develop a green taxonomy and harmonize definitions and classification systems for green products | SB, SEPS, SCVS, JPRF, MAATE | NT | 83 |

* I: Immediately (less than one year); NT: near term (1-2 years); and MT: medium term (3–5 years).

# I. BACKGROUND

## A. Macrofinancial Context

**1. The Ecuadorian economy rebounded in 2021 and 2022 in the wake of the COVID-19 pandemic.** Following a sharp contraction in 2020 as Ecuador was hit by the pandemic and a sharp fall in oil prices and export demand, the economy rebounded in 2021 and 2022. High oil prices have supported Ecuador's external and fiscal balances, with the public sector in 2022 posting the lowest deficit since 2008. Inflation accelerated in 2022 reaching 3.5 percent (well below regional peers) but has since moderated. In December 2022, Ecuador completed a 27-month Extended Fund Facility Arrangement with the International Monetary Fund.

**2. The financial sector has remained stable but has yet to fully absorb pandemic-related losses**. Banks' average capital ratios were around 15 percent of risk-weighted assets as of end-December 2022. Reported nonperforming loans (NPLs) are moderate, including on an augmented measure that includes refinanced and restructured loans. The acceleration of credit growth in the aftermath of the pandemic contributed to a mechanical dilution of NPL ratios. Since mid-2022, however, credit growth has slowed, and liquidity conditions have tightened considerably. Competition for deposits between banks and credit cooperatives increased funding costs which, combined with ceilings on lending rates, has led to margin compression. Pandemic-era decrees requiring banks to provide financial relief to certain categories of borrowers may have weakened the payment culture and affected the quality of credit data. Overall, cooperatives have higher NPL ratios and lower loan loss provisions than private banks.

## B. Development Challenges

**3. Financial repression, informal channels and low adoption of digital financial services explain the modest progress in the use of formal financial services in Ecuador.** Despite significant progress in access indicators, including narrowing the gender and income gaps, Ecuador lags behind regional comparators. The financial sector is relatively small and undiversified, dominated by banks and cooperatives. Financial institutions provide mostly traditional products and there is very limited innovation and development of digital products and services to reach underserved and financially excluded segments. There is potential for cooperatives to play a more frontier role in expanding financial services to unserved firms and individuals. Rapid credit growth in recent years has been uneven among different credit segments, with credit to the productive sector (33 percent of total) losing ground to consumer credit (39 percent of total). As of end 2022, SME credit represented less than 5 percent of total credit and microcredit 19 percent.

**4. Despite progress on financial inclusion indicators, a fairly large portion of the population, disproportionately poorer individuals and women, do not have access to transaction accounts, and cash dominates retail payments.** In 2021, 47 percent of adults made or received a digital payment (the share for females falls to 40 percent, and for the poor to 28 percent).[3] Effective use of transaction accounts is hampered by high costs and uneven coverage of access points Regulated basic accounts and debit cards are not widespread. The usefulness of digital wallets is reduced by the lack of full interoperability. Electronic payment acceptance is scarce amongst small merchants, whose thin cash flows are affected by traditional card-based business models and tax withholding. Slightly more than a fourth of Ecuador's municipalities are not covered by the financial sector, while half only have one access point. Few private banks have agent networks, while cooperatives rely almost exclusively on branches. Some financial institutions forged alliances with third parties offering bill payments and other services (e.g., credit installment payments) outside this framework.

5. **Capital markets in Ecuador have not developed because the critical preconditions for a local bond market to emerge are still lacking.** Recurring external debt defaults, structural macroeconomic imbalances, and the absence of a long-term savings industry suggest that market development should be approached as a gradual, long-term endeavor. However, actions to improve the functioning of the government bond market should begin sooner rather than later, in order to provide price references to the banking and the corporate sector in the capital market.

6. **In more developed markets, government securities are highly liquid and constitute one of the banking system's first lines of defense against liquidity risk.** The current conditions in the Ecuadorian debt market restrict the use of government securities for banks to meet unexpected liquidity needs, since there are no solid price references or a functional secondary market. A more active bond market will not only provide a robust financing alternative to the government but will also mitigate the vulnerability of the financial system to liquidity shocks.

7. **Deposit taking institutions are subject to financial repression measures.** Banks and credit cooperatives are subject to ceilings on lending rates. Financial institutions are required to maintain at least 60 percent of their liquid assets in Ecuador, facilitating domestic financing to the government at the expense of risk diversification at the systemic level. Private banks are also required to maintain minimum investments in government securities, public banks and public institutions at non-market prices. A tax on financial outflows that helped shield the domestic financial system from volatile capital flows was reduced from 5 to 4 percent in 2022 and is to continue gradually dropping to 2 percent by end-2023. Banks and investment companies are also subject to a 0.25 percent monthly tax on funds and investments held abroad.

## C. Financial System Structure and Recent Developments

8. **Ecuador's financial sector is dominated by banks and credit cooperatives.** The IMF Financial Development Index ranked Ecuador 133 out of 192 countries in 2019, the lowest ranking among peer countries. Financial institutions provide mostly traditional products and there is limited development of services to reach underserved and financially excluded segments. Total deposit-taker

[3] Global Findex 2021 – Refers to the poorest 40 percent of the population.

assets are around 78 percent of GDP, of which private banks account for 50 percent. Credit cooperatives have become increasingly important over the last decade and have total assets of around 20 percent of GDP. In addition, the funds of the social security administration are managed by the BIESS, the largest financial institution in the country. While BIESS does not take deposits and has not issued other types of liabilities, its mortgage credit portfolio represents about 6 percent of GDP.

**9. The domestic capital market is at a nascent stage**. Market capitalization at 7.8 percent of GDP in 2022, is much lower than that of neighboring countries, while trading of equity in the secondary market is negligible ($40 million in 2022). Government and corporate bonds placed through public offerings represented less than 3 percent of GDP in 2022, far below peer countries. Government bonds represent the largest fixed income instrument, though these are rarely traded in the secondary market.

**10. Lending to the private sector has expanded significantly in recent years, which may have led to the build-up of vulnerabilities in the financial system**. After gradually increasing from 25 to 30 percent of GDP between 2010 and 2017, credit to the private sector began a period of strong expansion up to 48.8 percent of GDP in 2021. Strong credit growth continued into 2022, with nominal credit expanding 16 percent year-over-year in September 2022. These dynamics were driven both by private and public commercial banks (of all sizes), which provided 67 percent of total credit, as well as the surge of lending by cooperatives, which now represent 27 percent of the lending to the private sector. The remainder of deposit-taking institution credit to the private sector is provided by public development banks, mainly Banecuador. BIESS provides a further ~10 percent of GDP in private sector credit. While credit expanding more quickly than output deepens the financial system and helps promote economic growth, the combination of interest rate ceilings and deficiencies in financial infrastructure and supervision raise questions about the quality of the increased lending.

**11. The COVID crisis affected bank profitability, especially for public banks.** The return on assets (ROA) of banks hovered at about 2 percent since the 2000 crisis, then fell to 0.5 percent in 2020 as a consequence of the COVID-19 crisis. While private banks, and especially larger ones, have seen a modest recovery in profitability in 2021 and 2022, the ROA of public development banks[4] declined further to -2.6 percent in 2021 driven by heavy loan loss provisioning by CFN to only recovered in 2022 to 1.5 percent. As for cooperatives, their average ROA was closer to 1 percent in the five years prior to the pandemic, falling to 0.4 percent in 2022. Bank capital ratios have remained stable. The level of liquidity in Ecuador is lower than in peer countries.

[4] Excluding BIESS and Banco del Pacifico

# II. RISK ASSESSMENT[5]

## A. Vulnerabilities and Risks

**12. Ecuador's exposure to macrofinancial risks and global spillovers is shaped by its fully dollarized economy and its position as an oil exporter.** The corporate and household sectors do not appear overly indebted, and mortgage lending is modest. However, banks and cooperatives have not fully recovered from the impact of the pandemic and now face new challenges stemming from tightening financial conditions and ongoing political uncertainty. Direct exposures to sovereign risk are limited, but indirect effects and the presence of public banks and BIESS also entail channels of contagion between the financial and the public sectors. Market risks are immaterial, including interest rate risk in the trading and banking books. The financial sector is vulnerable to an abrupt slowdown in China and the United States accompanied by falling oil prices. Additional sources of systemic risk include political and social discontent that could affect economic activity and possibly lead to sub-optimal financial sector policies.

## B. Stress Tests

**13. The FSAP assessed the resilience of banks, credit cooperatives and non-financial corporates.** The analysis is based on a baseline and an adverse scenario spanning three years (2023–25), in addition to a high-level assessment of the financial sector exposure to physical and transition climate-related risks. Both scenarios are challenging, as their starting point includes the effects of the pandemic and the social turmoil in mid-2022. The baseline scenario follows the April 2023 WEO projections, assuming a weakening external environment. Financial conditions are affected by the tightening of monetary policy in industrial countries and appreciation of the US dollar. The adverse scenario assumes sharper than expected slowdowns in China and the United States and increases in inflation and policy rates in industrial countries.[6]

*Bank Solvency Stress Tests*

**14. At the aggregate level, the banking system appears profitable enough to absorb the losses stemming from the adverse scenario.** While solvency ratios of a relatively large number of banks dropped below the minimum capital adequacy ratios (CAR), aggregated capital shortfalls were small. Aggregate bank profits contribute to material internal capital generation even under the adverse scenario. Credit losses and distributed dividends are the main drag on solvency. Large interest rate and sovereign risk shocks in the adverse scenario had only moderate solvency impacts due to short duration assets and already-high spreads.

*Cooperatives Stress Tests*

[5] Please refer to the IMF's TN on "Financial Stability Analysis and Stress Testing".

[6] More details on the scenarios and results of the stress tests can be found in the IMF's Financial Sector Stability Assessment (FSSA).

**15. The results suggest that several cooperatives could face solvency challenges.** The materialization of the adverse scenario would increase expected losses, particularly for the microcredit portfolio, and reduce profitability and capital adequacy. By 2025, the capital adequacy ratio of 35 cooperatives, representing about 6 percent of system assets could be below the 9 percent minimum requirement. The aggregate capital shortfall, however, is relatively small at 0.2 percent of GDP.

*Liquidity Stress Testing*[7]

**16. Results suggest that banks do not hold enough liquid assets.** The core assessment comprised three scenarios that imposed a drawdown of bank liabilities following the Basel LCR weights. Under the least severe scenario, three of the six banks accounting for about 25 percent of system assets fall below the reference LCR. Under a more realistic exercise assuming that domestic securities could not be monetized, five banks accounting for 37 percent of system assets drop below the reference LCR.

**17. Systemic liquidity is the main risk to financial stability given the lack of a domestic currency and insufficient foreign assets**. A systemic liquidity analysis compared estimated bank liquidity shortages against their claims on the liquidity fund. Half of the sampled banks maintain insufficient claims on the liquidity fund to restore a 100 percent LCR, with one medium-size bank displaying a liquidity deficit 3.7 times larger than its claims. However, two systemically important banks were able to cover their liquidity deficits with resources from the liquidity fund. Extrapolation of the results for the pilot banks suggests a system-wide liquidity deficit of about USD2.9 bn. This vulnerability underscores the pressing need for the authorities to begin work on the enabling conditions for the development domestic capital market, as recommended in Section V-D and Appendix II. It should also be noted that the rollout of real-time gross settlement would increase liquidity needs in the payment system and require effective intraday liquidity management, as noted in Section V-C.

*Nonfinancial Corporates*

**18. The corporate stress test indicates that debt-at-risk is not an imminent threat to financial stability.** A corporate stress test with the FSAP scenarios translated into sectoral-level impacts was carried out covering the entire population of registered firms with available financial statements. Results show that aggregated debt-at-risk, measured by the debt of companies with an interest coverage ratio (ICR) below 100 percent, is about 6 percent of GDP. Overall, the migration of companies to lower ICRs appears moderate, which is likely due to their relatively low indebtedness.

*Climate-Related Risks*[8]

**19. Ecuador's high exposure to natural hazards poses physical risks for banks and credit cooperatives.** Ecuador has the 13th largest exposure in the world to natural hazards and past natural disasters have caused significant economic and social damages. Large parts of the country are

[7] The assessment of liquidity risk was constrained by data availability. It relied on the results of a recent pilot project on the Liquidity Coverage Ratio (LCR). More details can be found in the IMF's FSSA.

[8] Please refer to the WB TN on "Climate and environmental Risks and Opportunities".

vulnerable to floods, landslides and droughts and climate change is expected to further exacerbate the intensity and frequency of extreme climatic events. Additionally, Ecuador's location along the 'Pacific Ring of Fire' and the interaction of tectonic plates exposes large parts of the county to high volcanic and seismic risks. A substantial share of credit extended by banks and credit cooperatives in Ecuador is located in cantons that are vulnerable to these natural hazards. A high-level assessment conducted by combining the geographic risk exposure with estimates for sectoral vulnerabilities gauges that up to 20 percent of bank and 25 percent of cooperative loans may be directly exposed to physical risks (Figure 7).

**20. Transition risks stem primarily from a high loan exposure to the agriculture sector**. Ecuador has a relatively low greenhouse gas emission profile but around 23 percent of system-wide bank loans in Ecuador are extended to borrowers in sectors that are considered as 'transition sensitive'. The overall exposure to transition sensitive industries is driven by a high loan exposure to the agriculture, forestry, and fishing sector, followed by exposure to heavy industry and the transport sector (see Figure 7). In contrast, the economically important fossil fuel sector received only a very small share of domestic bank loans in 2022. The aggregate exposure number hides significant differences across institutions with some banks having substantially higher exposure to transition sensitive industries.

**21. Despite Ecuador's exposure to physical and transition risks, no comprehensive climate-risk assessment has been conducted to date as limited knowledge and unclear responsibilities across the financial sector authorities impede progress.** It is thus important to clarify the respective roles of the JPRF, the BCE, the SB and the SEPS in monitoring and assessing climate-related risks from a system-wide financial stability perspective. Authorities should then utilize the granular spatial and sectoral information available on bank and cooperative loans as well as hazard and climate data to perform a top-down exposure assessment of the banking and cooperative sectors' vulnerability to climate risks. Such an exercise can help to inform supervisory strategy and priorities related to climate risks at a later stage.

**22. The supervisory response to climate and environmental risks is at an early stage and should be strengthened through increased capacity and resources at the superintendencies as well as enhanced inter-agency cooperation.** Neither the SB nor the SEPS have yet formalized governance arrangements or committees on environmental and climate risks as part of their institutional arrangements. None of the authorities have a dedicated team or full-time resources working on this topic and a more strategic focus on capacity-building efforts will be needed to enhance internal expertise. Inter-agency cooperation between the superintendencies is limited and similar initiatives have been pursued independently and in isolation. Enhanced coordination, for example through joint working-groups and strategic initiatives, could create synergies and efficiencies, which may be particularly important amid the resource constraints faced by the superintendencies. It would also help to ensure consistency of the emerging frameworks and reduce risks of regulatory arbitrage once rules become more binding.

**23. Supervisory actions taken so far have focused on environmental and social risks with no direct regulatory or supervisory actions taken on climate risks.** Spearheaded by the SEPS, authorities have issued resolutions requiring financial institutions to develop environmental and social risk management frameworks (or 'SARAS' as per the acronym in Spanish) in 2022. In the credit cooperative sector the SEPS resolution establishes clear requirements for governance, procedures, and monitoring of SARAS and has already spurred the adoption of environmental and social risk management frameworks in the sector. In contrast, many banks already had SARAS in place and do not face additional requirements stemming from SB's resolution and it remains to be seen if it stimulates over time a convergence in environmental risk management practices across banks. Authorities should stand ready to fine-tune the SARAS regulations, support implementation and ensure effective monitoring. No supervisory action or guidance have yet been issued related specifically to climate risks, i.e., the risks that financial institutions face from loan or investment exposures to physical and transition risks. While the initial focus on environmental risks is reasonable, over time authorities should develop a strategy for expanding the focus of supervisory attention from environmental to climate risk management.

# III. FINANCIAL SECTOR OVERSIGHT

## A. Cross-cutting Issues

**24. Coordination and information-sharing between the large number of institutions playing a role on financial sector issues is lacking.** Often, regulatory proposals are developed in isolation, financial stability analysis only considers specific segments of the financial sector. This document presents several financial sector topics in which the authorities have the opportunity to materially enhance their effectiveness by improving coordination between government agencies. Of note, the macroprudential framework calls for system-wide financial stability oversight (see Section III-B); information needs to be shared in a timely manner to effectively prepare for the failure of weak institutions (see Section IV); SOFI reform must align their mandates in a comprehensive manner (see Section V-I); the implementation of the National Financial Inclusion Strategy (NFIS) will demand much closer inter-agency coordination to be effective (see Section V-B), as will be the case for the Fintech Law (see section V-C); the development of the preconditions for domestic capital markets demands broad and coordinated efforts by MEF, regulators, state-owned entities and the private sector (see Section V-D); and an efficient development of green financial markets must bring all relevant stakeholders to a common dialogue to mitigate the risk of 'green washing' (see Section V-E).

**25. The superintendencies should play a large and active role in the regulatory process.** The organic law grants comprehensive powers to the JPRF to issue regulations. The superintendencies, however, have a direct knowledge of the sectors that they supervise and stronger analytical capacity. The JPRF should solely play the key role of coordinator and ultimate authority on regulatory issues, particularly to harmonize cross-sector regulations and implement timely macroprudential actions. The superintendencies should have an active part in the regulatory process including by proposing regulations, conducting joint impact analysis, and opining on all regulatory matters applicable to the entities that they supervise.

**26. Effective micro and macroprudential policies and tools can be built under different oversight architectures.** Often, maintaining the stability of existing institutions and focusing on addressing their weaknesses, tend to generate better and faster results than unifying or dismembering agencies, as such processes tend to distract from the underlying shortcomings. Initiatives that are critical to the effectiveness of institutions should be fully implemented, as in the case of the new risk-based supervision framework by the SB, as recommended in Section III-C. Financial sector authorities should devise a comprehensive plan to bridge the large gap between their current practices and international standards. More generally, these institutions need greater political independence, adequate supervisory powers, trained staff and tools to fulfill their mandates, as noted in Section III-C and Section III-D.

**Table 2. Institutional Framework for Financial Sector Oversight**

| Institution | Mandate / Role in the Financial Sector Policies |
|---|---|
| Ministry of Economy and Finance (MEF) | • Responsible for legal framework.<br>• Any use of public funds.<br>• Governance of public banks. |
| *Junta de Política y Regulación Financiera* (JPRF) | • Prudential rulemaking.<br>• Setting of interest rate ceilings.<br>• Financial stability report coordination. |
| *Junta de Política y Regulación Monetaria* (JPRM) | • Stability of the monetary and payment systems, and coherence of dollarization.<br>• Setting of reserve and liquidity requirements.<br>• Oversight of the BCE. |
| *Banco Central del Ecuador* (BCE) | • Implementation of JPRM policy.<br>• Oversight of payment systems.<br>• Supports JPRF stability analysis. |
| *Superintendencia de Bancos* (SB) | • Supervision of banks. |
| *Superintendencia de Economía Popular y Solidaria* (SEPS) | • Supervision of cooperative deposit-takers (and non-financial cooperatives). |
| *Superintendencia de Compañías, Valores y Seguros* (SCVS) | • Supervision of financial markets, securities issuance, and insurers. |
| *Corporación del Seguro de Depósitos* (COSEDE) | • Deposit insurance payout; asset & liability transfers in liquidation.<br>• Management of the Liquidity Fund. |

## B. Macroprudential Framework[9]

**27. Authorities are committed to strengthening the macroprudential framework; it is key that current efforts are expanded as the framework has several shortfalls.** Initiatives such as a common definition of financial stability, plans to produce a financial stability report, and data collection efforts need to be expanded. These need to address a framework that is overly complex and unclear, lacks a systematic process for authorities to monitor system-wide financial stability risks, and has no macroprudential tools in place despite the existence of legal framework for some, such as additional capital buffers reflecting the phase of the credit cycle and systemic importance of banks.

**28. To enhance the macroprudential framework the authorities should**: (i) Clarify the macroprudential objectives, functions, and powers of each agency, with JPRF as the overall coordinator; (ii) Strengthen coordination arrangements and practices between agencies, establishing a systematic process to monitor and evaluate system-wide risks, including the establishment of a Financial Stability Committee in charge of the analysis of systemic risks; (iii) Improve data collection, reinforce data sharing among agencies, and enhance analytical capacity; (iv) Implement the Basel III buffers (conservation, countercyclical and for domestic systemically important banks), and borrower-based measures; (v) With appropriate phasing, remove the requirement to hold 60 percent of liquid assets in domestic assets to strengthen system-wide liquidity.

## C. Banking Regulation and Supervision[10]

**29. The Superintendency of Banks (SB) has recently taken several initiatives to enhance banking supervision.** These initiatives include efforts to develop and implement a supervisory stress testing program and studies to enhance prudential requirements, including the planned implementation of the LCR.

**30. Notwithstanding these efforts, institutional shortcomings impair sound banking supervision**.

- **Safety and soundness are not the primary goal of the SB which, in practice, results in the prioritization of SB's broader responsibilities over prudential goals.** The SB has a very broad mandate (including, *inter alia*, consumer protection, enforcement of interest rate ceilings, social security oversight, bank resolution etc.). These other duties often disrupt prudential supervisory planning and consume a significant amount of time and resources. The law should recognize safety and soundness as the primary objective and the internal structure should segregate units dedicated to prudential and non-prudential duties.
- **The legal independence of the SB has many practical constraints that have generated substantial institutional instability.** The appointment procedure for Superintendents is prone

[9] More details on the macroprudential framework can be found in the IMF's FSSA.

[10] Please refer to the joint IMF-WB "Detailed Assessment of Observance – Basel Core Principles for Effective Banking Supervision".

to disputes and the removal procedure is excessively discretional. These characteristics have led to high instability at SB's senior positions that impair the continuity of work and deviate the attention of senior managers to non-prudential topics. The administrative autonomy of the SB is also undermined by the significant number of requests from other State authorities and the need for consent from the Ministries of Finance and Labor for budget decisions and changes in internal organization. Laws and rules should be reformed to ensure that the SB is able to self-organize and to administer its staff and budget efficiently, stably, and independently. The rules for appointment of the Superintendent need to be strengthened to restrain discretion on removals.

- **Lack of a career plan and a sound training program has significantly hindered the acquisition and retention of talent**. The turnover of staff and management of the SB is very high, hindering the accumulation of supervisory knowledge and the implementation of projects.

31. **The supervisory approach needs to be substantially strengthened.** The SB transitioned to a new risk-based supervision framework which was implemented without being fully developed. Shortcomings include the absence of a supervisory cycle, insufficient guidance to supervisors, an incomplete and fragmented view of banks, absence of modules to directly examine risks and reduced attention to non-credit risks. Overall, examinations and monitoring of individual risks and banks are mostly descriptive, lacking a proper assessment of bank soundness and of risk management and corporate governance processes and policies. The SB still has a strong inclination towards compliance-based supervision, is not well equipped to exercise supervisory judgement and the current methodology does not ensure consistent procedures and comprehensiveness. The SB also lacks a regular program of supervisory stress tests and review of bank's stress tests.

32. **The SB has an adequate range of supervisory tools to impose timely corrective actions, but some supervisory powers are missing and there is a high risk of judicial reversal of supervisory actions.** The SB should have the power to increase prudential requirements for individual banks and banking groups based on their risk profile and systemic importance. The SB should also be able to designate temporary administrators, when necessary, instead of requesting the shareholders to replace senior management. In addition, maximum sanctions are too low to function as an effective deterrent. Finally, the legal base for corrective action applied to banks that are not subject to "intensive supervision" could also be enhanced by adding a catalogue of specific measures, in addition to the existing general clause. Special procedures should be regulated for the judicial review of the most important supervision and resolution decisions (allowing for monetary compensation but not for retroactive reversal).

33. **The banking supervisory and regulatory framework would also benefit from further progress in several other areas, including**:

- **Consolidated supervision** should be enhanced by a more comprehensive supervisory perimeter and regular group-wide examinations.
- **Capital and liquidity regulation** should gradually align to the Basel Framework, particularly in relation to the definition of capital and Pillar 2 requirements. Banks should also be required to adopt a forward-looking approach to capital and liquidity management.

- **Corporate governance** requirements should be strengthened to properly determine the responsibilities and functions of senior management; supervisory procedures should be enhanced in order to and better assess the effectiveness of the board's risk oversight.
- **Corporate exposures** classification and provisioning needs further supervisory attention. While non-corporate exposures are classified based on past dues in a conservative way, corporate exposures are classified based on expert models and currently result in less provisioning than IFRS 9, as these models don't properly account for macroeconomic conditions and shocks.
- **Accounting criteria** should be aligned to IFRS. The qualification process applied to external auditors also needs to be strengthened.
- **Supervisory response to climate and environmental risks** is at an early stage and should be strengthened.

## D. Cooperative Regulation and Supervision[11]

**34. Authorities are making an ongoing effort to converge prudential regulatory requirements of large cooperatives with those applied to banks.** Authorities have been working on the harmonization of capital, loan classification and provisions, and liquidity requirements of cooperatives with that of banks to address potential regulatory arbitrage. Differences remain in reserve requirements and contributions to the liquidity fund, but convergence is underway, and expected to finish in 2025 and 2027, respectively. Cooperatives are allowed to retain up to 3 percent of loans to enhance their capital, which constitutes a meaningful competitive advantage relative to banks when the interest ceilings are binding.

**35. Sound supervision is impaired by the shortcomings of SEPS's legal powers and a supervisory approach that is limited in terms of scope, risk profile assessments and adoption of early corrective actions.** The SEPS cannot remove cooperatives' council members for technical breaches and corrective actions are limited to cooperatives under intensive supervision programs. The supervision plan is not based on a comprehensive supervisory cycle and onsite assessments are relatively limited. Timely identification of higher-risk entities is hampered by a risk classification methodology based on quantitative indicators and a score aggregation method that underestimates the importance of qualitative indicators.

**36. The supervision of the largest cooperatives needs substantial improvements.** The SEPS assesses the same issues in both offsite and onsite supervision, with a supervisory approach that is not forward-looking, and supervisors do not challenge cooperatives' strategies, policies, and methodologies enough. Considering that the operations and business models of the largest credit cooperatives are closer to banks than the other cooperatives, authorities could consider transferring the supervision of the largest cooperatives to the SB, though this should be accompanied with capacity strengthening of SB (as per Section III-C) and would demand major legal reform. The transfer

[11] Please refer to the IMF's TN on "Cooperatives Regulation and Supervision".

could enhance the efficiency and effectiveness of supervision by grouping institutions that require a similar supervisory approach under the same superintendency.

37. **The cooperative supervisory and regulatory framework would also benefit from closing gaps in several areas**, including: (i) Setting expectations on corporate governance and risk management proportional to the size and risk profile of cooperatives; (ii) Establishment of minimum requirements for evaluation, approval, and monitoring for each type of loan; (iii) Strengthening oversight of loan classification and provisioning to detect potential evergreening practices; (iv) Gradual alignment of capital and liquidity requirements to the Basel Framework, with proportional simplification of the requirements for small cooperatives; (v) Strengthening of the supervisor's skills, through comprehensive and specialized training programs.

## E. Financial Integrity (AML/CFT)

38. **Ecuador has started the reform of its AML/CFT framework based on the findings of the latest Mutual Evaluation Report; political commitment is key for further progress.** The enactment of the New Organic AML/CFT Law, currently pending in the National Assembly, is critical. Although the National AML/CFT Strategy was approved, its publication and the engagement with the private sector are still pending. Furthermore, an updated National Risk Assessment is underway, including additional modules on tax crimes, environmental crimes, assessment of legal entities, state-owned entities, nonprofit organizations, and crypto assets.

39. **Resource constraints could overburden the effective AML/CFT supervision of the financial system.** Modifications to the AML/CFT framework should apply a risk-based approach and avoid an overly expansive scope. The main AML/CFT coordination body, CONALAFT, is currently operationalizing its mandate, bringing needed collaboration among different authorities. SB, SEPS and SCVS have also started to update their internal regulations and *Unidad de Análisis Financiero y Económico* (UAFE–- Financial Intelligence Unit), the designated supervisory entity of virtual asset service providers, is currently requesting entities to use a self-registration process. Political commitment to strengthen these areas with adequate budget, technical and human resources is critical.

# IV. FINANCIAL CRISIS MANAGEMENT AND RESOLUTION[12]

40. **Ecuador has multiple resolution authorities**. The SB, SEPS and the deposit insurer (COSEDE) all play a role. The superintendencies implement corrective actions and resolve failing or failed institutions. COSEDE both provides deposit insurance and finances resolution measures. The supervisory authorities do not require member institutions to prepare recovery plans nor do the SB and SEPS prepare resolution plans.

[12] Please refer to the IMF's TN on "Financial Sector Safety Net".

**41. The FSAP identified several priority areas for strengthening the resolution framework:** (i) The supervision and resolution functions should be separated, either by establishing an independent department within the SB/SEPS or by shifting responsibility for resolution to COSEDE; (ii) Resolution tools should be strengthened by converting the "exclusion and transfer of assets and liabilities" (ETAP) instrument to a more traditional P&A (purchase and assumption) power and by establishing tools for resolving systemically important institutions; (iii) The preparation time for resolution should be lengthened and needed data provided in advance of failure.

**42. Over the medium term, an overhaul of the legal framework for resolution is warranted.** The authorities should consider the introduction of a comprehensive financial institution resolution law. That law would establish a resolution agent, separate from the supervisory function. It should establish a more comprehensive resolution tool kit and address the limitations of the current tools. In particular, the law should introduce bridge-bank and bail-in powers**.** A tighter timeline for the implementation of resolution actions should be established. Legal certainty of resolution actions needs to be enhanced given that judicial review of supervisory actions is very broad.

**43. The deposit insurer has some strong practices but also weaknesses that need to be addressed:** (i) The governance of COSEDE should be strengthened to include independent members appointed to the Board; (ii) Payout time should be shortened, as it is based on receiving depositor data from the liquidator, which can add up to 60 days to the process; (iii) COSEDE staffing should be improved from only 6 permanent staff and 50 secondees from other institutions; (iv) Funding of COSEDE should be strengthened, despite the substantial ex-ante fund; (v) Limit the use of its resources to the amount it would have paid out to insured depositors in a liquidation; (vi) Introduction of clear legal foundation for depositor preference.

**44. Given dollarization, Ecuador operates an industry-funded Liquidity Fund in the absence of a standard lender-of-last-resort regime.** The Liquidity Fund is a government-mandated industry support mechanism where institutions deposit their funds and can borrow them back in the absence of an emercency liquidity facility from the BCE. However, access is limited to the amount of bank equity and is over-collateralized, and the practices for posting collateral are untested. Accordingly, the liquidity fund would only have a limited role during widespread financial distress or a significant deposit run. Consideration should be given to the development of a more flexible lender-of-last resort facility, although its scope will remain limited by dollarization.

# V. FINANCIAL SECTOR DEVELOPMENT

## A. The Role of the State in the Provision of Financial Services[13]

**45. The State plays an important role in the provision of financial services in Ecuador through state-owned financial institutions (SOFIs) and interest rate controls.** Six SOFIs in Ecuador hold thirty six percent of total financial sector assets, operating in asset management, commercial banking and development banking[14]**.** SOFIs are key actors in mortgage and microcredits segments. SOFI market share has declined in recent years and SOFIs did not play a countercyclical role during COVID. Nevertheless, the SOFI sector in Ecuador is among the largest in Latin America relative to the banking sector. Another key avenue for state intervention in the financial system are interest rate ceilings, which are implemented on all credit in Ecuador.

**46. There is no comprehensive reporting or evaluation for public credit programs and SOFI interventions which makes it difficult to evaluate costs and assess value for money, but performance problems reveal important inefficiencies.** Ecuadorian development banks (DB) monitor disbursements and beneficiaries of their interventions but collect little information on borrowers which prevents assessing financial and economic additionality of the interventions.[15] Fiscal costs of public credit support programs and SOFI operations are not aggregated and disclosed. While it is not possible to determine value for money and impact of DB interventions, the low disbursement of public credit programs, lack of interest of private institutions to implement public programs, SOFI portfolio quality problems and low efficiency indicators point to substantial inefficiencies.

**47. SOFIs in Ecuador have operated within a legal, regulatory, governance and organizational frameworks that appears to be far from international good practices.** Chapter IV of COMYF dedicated to SOFIs has had very negative consequences for the definition of their mandate and objectives, impacting the quality of their portfolios, their profitability, solvency and liquidity, and questioning their developmental results. The COMYF is not sufficiently clear with regard to ownership policies, and roles and responsibilities of SOFI shareholders and boards, and points to several other documents rather than providing a single reference point. It also has imposed risks to fiscal management, through large contingent liabilities. The need for a separate COMYF Chapter for SOFIs should be reassessed and an ownership policy should be developed including: (i) objective criteria to merge, divest, or keep SOFIs; (ii) criteria to justify ownership of the State in SOFIs; (iii) transform SOFIs into joint-stock companies, (iv) establish a centralized unit at the MEF dedicated to exercise ownership/monitoring function; (v) ensure transparent nomination and removal processes for board

[13] Please refer to the WB's TN on "The Role of the State in the Provision of Financial Services".
[14] These are *Banco del Instituto Ecuatoriano de la Seguridad Social (BIESS), Banecuador, Banco de Desarrollo de Ecuador (BDE), Banco del Pacifico (BdP), Corporación Financiera Nacional (CFN) and Corporación Nacional de Finanzas Populares y Solidarias (CONAFIPS).*

[15] Ecuadorian DBs include all SOFIs with the exception of BdP, which runs under a commercial bank mandate.

and management, and strengthen fit and proper requirements to include expertise; (vi) design of performance contracts linked to targets, indicators, and overall strategy of each SOFI. Such a policy could take different legal forms, from a dedicated law to a Cabinet policy, and would provide an accountability set up that keeps management focused and enhances arm's - length operations.

**48. SOFIs are subject to prudential requirements but supervision and enforcement needs to be intensified.** The SOFIs that are supervised by the SB are subject to the same prudential requirements as private banks, except for the BIESS given the nature of its operations. The CONAFIPS, which is supervised by the SEPS, has seen its prudential regulatory requirements harmonized with those by SB. Nonetheless, many SOFIs have deficient credit risk management processes and IT systems that have been long unaddressed. SB and SEPS should ensure portfolios are properly valuated and losses recognized and effectively enforce regulations.

**49. Public credit support programs, largely implemented by SOFIs, should be redesigned to enhance effectiveness. Expectations of debt forgiveness should be eliminated.** Public credit programs should be part of broader interventions including business advisory services to support viability of the borrowers. Programs should focus on viable but un-bankable new borrowers to ensure additionality and avoid crowding out private credit providers and include incentives for loan repayment. Credit subsidies should cover the cost of credit to ensure participation of private credit providers. Monitoring and evaluation systems should be put in place to assess the impact of public credit programs and development bank interventions beyond disbursements as well as the costs of such interventions. Governments should cease the practice of forgiving DB loans, sending frequent messages on the importance of loan repayment and for financial inclusion to be done in a sustainable manner. Instead of debt forgiveness, catastrophic insurance schemes could be set-up beforehand, to provide payouts to vulnerable populations in emergency situations (e.g., natural disasters, pandemics etc.).

**50. The legal framework should be revised to ensure an even playing field between SOFIs and private firms.** BIESS has a monopoly on the administration of social security resources, concentrating the available long-term funding in the market, while other DBs receive resources from private banks at regulated rates through mandatory investments. BIESS is also the only bank that can extend consumer loans secured with workers contributions to individual retirement accounts (e.g. *fondos de censantia)* and with direct discount to payrolls. SOFIs can collect debts through special procedures (*coactiva*), albeit in practice most institutions have been reluctant to use them.

**51. The envisioned merger of CFN and Banecuador should be reconsidered and halted, though consolidation of the public banking sector could still be desirable.[16]** CFN funds itself in wholesale markets to facilitate access to credit to business through financial intermediaries while Banecuador offers savings accounts and microcredits. The merger of institutions with different business models and market segments does not generate synergies. Both institutions have presented portfolio quality problems and have exhibited the urgent need to revamp credit processes and IT

[16] After the FSAP mission, the merger of CFN and Banecuador was suspended until both entities strengthened their balance sheets and financial ratios. Executive Decree 902 / November 2023.

systems (though CFN has recently taken large losses and addressed operational weaknesses as per AQR recommendations). Banecuador consistently reports losses despite not properly classifying and provisioning assets, and hence needs integral reform, including product redesign, administrative autonomy and political independence, re-engineering processes and a massive upgrade of IT capabilities that calls for a frank cost-benefit analysis. On the other hand, the transition by CFN to a wholesale business model, which has provided positive results in terms of complementarities with the private sector and in terms of the financial health of the institution, should be incorporated in legislation and be supported by the creation of an asset management company inside CFN to deal with the legacy first-tier portfolio. As for other potential SOFI consolidation, the feasibility of a merger of CFN and CONAFIPs could be analyzed. Both CFN and CONAFIPs have a similar business model and products and the merger could realize operational synergies.

**52. Banco del Pacifico (BdP) should continue improving asset quality indicators and boost profitability to support future privatization efforts. BdP could explore reaching to lower income segments without compromising the privatization goal.** BdP needs to improve credit quality indicators, increase provisions, and boost net interest margin and profitability to enable privatization. In the meantime, BdP could exploit its mobile payment app and the largest banking correspondent network in the country to efficiently disburse social programs, provided the fee paid by the government covers costs. The option of purchasing a microfinance institution with know-how could be assessed to support sound microcredit development. BdP could then provide a blueprint for other private commercial banks' sound expansion down-market which would support winding down *Banecuador* operations.

**53. The operational framework for BIESS could be enhanced to make it more alike to a fund administrator, including through revision to mandate and functions, operations, profitability requirements and transparency**. The BIESS mandate should be revised to place the focus on maximizing returns for pensioners. The mandate to administer private complementary pension funds, including affiliation and collection services, should be eliminated. The BIESS should be allowed to invest its resources in private administered funds subject to profitability requirements and investment guidelines and decline its loan investments. Reforms to level the playing field between BIESS and private banks would support the BIESS loan portfolio reduction and BIESS should report to credit bureaus. Minimum return rates should be set net of expenditures and consideration should be given to set different rates for different funds according to their investment horizon. An AQR of BIESS mortgage and trust investments should be conducted and BIESS should continue strengthening its credit risk management system including collection. Disclosure of BIESS performance as an asset administrator should be enhanced.

**54. Ecuador's current interest rate ceilings scheme has perverse effects on financial inclusion and should be reformed.** The scheme has undergone several changes that compromise its transparency to the public and is characterized by a highly fragmented segmentation and only slight variation over time. By remaining invariant, ceilings negatively affect credit provision, competition, and borrower monitoring and selection. Several empirical studies explored the effects of interest rate ceilings in Ecuador, finding evidence of lower credit supply and an increase in the average loan size. Using information on new borrowers in the system, a reduction of 1 percentage point in the spread between interest rate ceilings and reference rates (a measure of how binding the ceilings are) is associated with a 10 percent decrease in the frequency of first-time borrowers. Effects are more prominent for large private and state-owned banks and for the consumer segment.

**55. It is recommended to migrate to a market-wide usury rate scheme to prevent predatory lending**. The transition to market-based interest rates should include a set of enabling conditions, notably the advancement of price discovery of risk-free rates through regular auctions of government securities complemented by the activation of interbank markets, as recommended in Section V-D and Appendix II. In the short term, authorities should reform the current scheme to accommodate the transition, with immediate attention to credit segments where ceilings are binding. As discussed in Section V-B, definition and segmentation of credit under interest rate regulation has an impact on SME lending, and therefore the evolution of the regulation should be devised to avoid excluding these firms, among other vulnerable segments. The final usury rate scheme should have a consumer protection focus, while efforts to promote financial inclusion should be directed through other tools more effective for that purpose.

## B. Access to Finance for SMEs[17]

**56. Ecuador has been making progress on financial inclusion indicators over the last decade, though it lags countries of similar income level.** In 2021, 64 percent of adults reported having access to a bank account with a financial institution, compared to 51 percent in 2017 and 37 percent in 2011. Access is below the LAC regional average (74 percent) and the average for upper middle-income countries (84 percent).

**57. Digital financial services, and more generally formal financial services, have only shown modest progress.** The proportion of the adult population that made or received digital payments reached 47 percent in 2021. Around half of the people that made a digital payment to a merchant or paid utilities, did it for the first time after the COVID-19 pandemic started. While 47 percent of adults borrowed money in 2021, just 23 percent did so from a formal financial institution or using a credit card, while 29 percent borrowed from family or friends. Similarly, 39 percent of adults saved money but only 13 percent using an account.

**58. Tightening of conditions have made interest rate controls more binding, negatively affecting access to finance for unserved and underserved segments.** Market interest rates have been increasing since the second half of 2022 in line with tightening global financial conditions. The corporate productive credit segment shows an increase in both the lending and borrowing rates, while prevailing lending rate ceilings have led to bank margin compression, influencing bank's willingness to lend. For the SMEs and microcredit segment, lending rates are more stable but the continued

[17] Please refer to the WB's TN on "Access to Finance for Small and Medium Enterprises".

increase in the funding cost has resulted in the lowest lending-deposit spread for microcredit in more than 5 years.[18]

**59. The financial sector offer does not adequately cater to the needs of the SME segment, neither in terms of volume of financing, nor in the type of financial products and services available.** Total credit from financial institutions in Ecuador accounts for 50.7 percent of GDP as of end-2022. Microcredit - as reported by financial institutions under the interest rate cap scheme-represents 10 percent of GDP and credit to SMEs accounts for less than 3 percent of GDP (Figure 5). Access to finance is the third most cited obstacle by firms after political instability and informal practices, with SMEs reporting greater constraints than large firms. Alternative credit products (i.e. invoice discounting platforms, marketplace finance platforms, integrated on-line merchant platforms and alternative credit scoring) to bridge the information asymmetry and collateral gaps in the SME segment are generally not available. Electronic invoicing tax systems can be a useful tool to facilitate factoring by increasing the reliability of SME invoices through a centralized process. Expanding cloud-based accounting linked to e-invoicing could help increase SME transparency and bankability.

**60. Frequent regulatory changes regarding the definition and segmentation of credit combined with the ceilings on interest rates have impacted the volume of SME lending.** SME credit growth for the period 2017-2022 has been modest (6 percent per annum) compared to the growth in private credit (9.2 percent) and microcredit (12.8 percent). Both the microcredit and SME segments increased the average loan amount. A significant part of SMEs may still not qualify for traditional bank financing due to informality, reliance on movable or intangible assets, limited documentation and capacity to demonstrate repayment capacity, in addition to sometimes their low profitability and short track record. The mismatch between financial and non-financial companies' legislation adds to the current limitations. Interest rate ceiling regulation limits the ability of financial institutions to adequately price risk and serve the SME sector. While the Commercial Code considers SMEs to be firms with sales of at least $300,000, the financial sector regulation established the SMEs credit segment as borrowers with sales of at least $100,000. This excludes micro firms as these are more costly to assess and with higher risks for the financial institutions though under current regulation cannot be charged a higher interest rate than larger firms, effectively hampering their access to finance. Microcredit is migrating from the lower segments, that are not financially viable under adequate risk-based pricing and current rate restrictions, to the upper segment with a higher average loan amount. As a result, and in addition to informal channels, SMEs end up relying on consumer loans or microcredit to satisfy their financing needs.

**61. Informal lending[19] and unregulated store credit offer access to financing for low income households and MSMEs (including those currently unbanked), but bring significant consumer protection issues.** Informal lenders often follow abusive collection practices and charge usury interest

[18] In June 2023, JPRF has partially acknowledged the issues arising from interest rate controls that are more binding by changing the methodology for two segments (*Productivo Corporativo* and *Productivo Empresarial*). While this measure has provided some relief to those segments, further reform will be needed in a transition towards an usury rate scheme.

[19] Informal lending includes loans provided by non-regulated institutions and may include private lenders (*chulqueros*) and pawn shops, among others.

rates. In addition, there are stores (*casas comerciales*), which provide access to consumer loans to low-income individuals (many of whom are unbanked). The *casas comerciales* are not covered by COMYF, and hence are not regulated or supervised. These entities do not comply with the same consumer protection requirements as financial institutions and are able to use the profit margin of the products on sale to effectively increase the financial cost of store credit significantly beyond interest ceilings. It is not uncommon for *casas comerciales* to sell their store credit portfolio to banks, introducing a bias towards consumer lending in the financial system.

**62. Cooperatives play an important role in the credit market with a focus on microcredit and consumer loans, though their business model and credit origination methodologies do not fully account for the associated risk.** Cooperatives increased their market share from 20.7 percent in 2017 to 31 percent in 2023. Microcredit lending represents 40.2 percent of the total lending by cooperatives, while credit to SMEs is less than 2 percent as of 2022. The continued increase in the average loan size together with the increase in loan maturity (more than 95 percent of microcredit loans maturities are over a year) indicates reduced access, particularly for smaller borrowers and underserved segments. The characterization of microcredit in the balance sheets follows the regulatory definition (based on the client's annual sales), but there is no underlying microfinance technology applied for credit origination. As a result, there is little difference between the origination of consumer and microcredit loans, apart from the interest rate applied to the end customer.

**63. The adoption and effective implementation of the NFIS is critical to start addressing binding constraints.**[20] The NFIS tackles key areas and most of the key issues constraining financial inclusion and access to finance. However, the fragmented institutional set-up has had a negative impact on the launch and effective implementation of the NFIS. Key challenges remain with regards to its governance and effective institutional coordination.

**64. The credit information system and financial infrastructure needs to be strengthened to support access to finance.** The supervisory authorities should have access to the consolidated data on credit. However, the information available through the credit bureaus is limited to credit only, restricted to the last three years of history, and does not include alternative sources of data -with the exception of *casas comerciales* and some telecommunications companies. There is no BIESS data[21] in any credit registry, an important source of credit in the system, particularly for mortgages. Furthermore, the Parliament has issued regulation that has wiped out the credit history in the past. Altogether, these issues effectively limit the opportunity to collect and provide information on a large group of potential clients that do not necessarily have formal credit, and thereby constrains financial inclusion. The information collected and shared by financial regulatory and supervisory authorities is fragmented and limited in scope. The SEPS does not have access to the full consolidated data for cooperatives' clients to monitor credit and indebtedness in the system. A memorandum of

[20] After the FSAP mission, the NFIS was approved by JPRF (Res. JPRF-P-2023-080; September 25, 2023).

[21] Starting July 2023, BIESS is required to submit its credit data to the Superintendency of Banks, which will enable this data to be incorporated into the credit bureau databases.

understanding (MoU) between the supervisory authorities should be established for the sharing of information on a regular basis.

**65. The legal and regulatory framework to enable the development of SME lending products needs to be developed.** The existing traditional banking and cooperative model combined with restrictive credit regulation does not support SME development. Alternative lending products not yet present in the market include leasing and factoring, invoice discounting platforms, marketplace finance platforms, integrated on-line merchant platforms and alternative credit scoring. An online collateral registry could contribute to the enhancement of the secured transactions framework. An integrated legal framework for secured transactions and corresponding judicial timeliness are necessary to ensure that contracts are enforceable. The development of the legal and regulatory framework to enable SME financing products needs to be accompanied by improvements in market practices, government support programs, along with training to judges for the interpretation and application of the legal framework.

**66. Ecuador's corporate and household insolvency regimes are outdated; the insolvency system needs to be overhauled and significantly enhanced to become workable and effective**. The fragmented approach of the current legislation should be replaced by a fully new and unified insolvency regime consistent with international best practices.[22] It should also strike a proper balance between reorganization and liquidation of enterprises in financial difficulties or insolvency. The rescue of a business should be promoted through formal proceedings as well as hybrid and informal reorganization procedures (workouts). The legal framework should also include a streamlined insolvency regime for micro and small enterprises, which constitute the majority of companies in Ecuador and currently do not benefit from a functional rescue mechanism and expedited and simplified exit.

**67. The authorities need to further assess the current business model of cooperatives to address potential gaps regarding credit methodologies and risk management practices to prevent over indebtedness.** Measures on this front should be accompanied by enhanced transparency in pricing and by market conduct supervision. The current fees and charges included as part of the loan origination process should be monitored and accounted for through a calculation of an effective interest rate or other measure of total financial cost. These should also be made widely available to the public. Some of these fees and costs include mandatory deposits of up to 20 percent of the loan amount and up to 3 percent of the loan amount for capital strengthening, which increase the effective interest rate above the interest rate ceilings. Estimates of the negative effect of interest rate ceilings on access to finance may present larger coefficients if effective interest rates or other measure of total financial cost were taken into account. This information would provide valuable insights into the effectiveness and impact of the current interest rate caps, as the effective interest rate charged by cooperatives may be revised upwards.

[22] In July 2023, the Ecuadorian government presented the proposed Law/Decree for enterprise restructuring to the Constitutional Court.

**68. Government policy and support programs should adopt an adequate measurement and evaluation framework, including impact evaluations when appropriate.** Current SME programs lack clarity regarding objectives or results in terms of impact and scale sought. Given the interest rate ceilings that currently exist in the market, it is not clear what type of market failure these interventions are trying to address. For example, recently launched programs focus on subsidizing the interest rate for loans of up to USD5,000 and USD20,000 (depending on the annual sales of the borrowing firm) rather than on expanding access to creditworthy borrowers currently reliant on informal credit sources. As of end 2022, at least $30 million has been allocated to this program by the Ministry of Production, in addition to budget allocations coming from other ministries with no clear indication on the effectiveness of such programs. It is also not clear whether this subsidy fully covers the cost of the program.

## C. Payments and Financial Market Infrastructures[23]

**69. The institutional arrangements for central bank financial market infrastructures (FMIs) are complex and do not clearly articulate oversight and risk-management responsibilities and accountability.** The BCE does not have an internal oversight body. The JPRM, which integrates the executive branch of the government, is responsible for the monetary policy and is the highest authority of the central bank, of which it sets the policy and supervises the discharge of functions. While the JPRM sets the overall policy of BCE operations, it does not effectively oversee the risk-management function and material risk decisions of BCE-operated FMIs. The BCE has implemented an oversight function for privately-operated payment systems/services although it does not oversee the BCE-operated FMIs. The law (Securities Market Law, SML) entrusts the securities market authority (SCVS) with the authorization and prudential supervision of central securities depositories and securities settlement systems (CSD-SSSs), including the BCE-operated DCV. Neither the BCE nor the SCVS have formally adopted the Principles for Financial Market Infrastructures (PFMI).

**70. There is no designated system or special procedure for large-value payments; in the current set-up, credit risk is not fully mitigated.** Within the *Sistema Central de Pagos* (SCP), the interbank payment system (SPI) is the largest system and the only system (informally) designated as systemically important payment by the BCE. SPI is a deferred net settlement (DNS) system mainly for customer-initiated payments, in which transactions are accumulated and netted throughout the day in three cycles. SPI participants are exposed to credit risk, managed through: (i) a Liquidity Fund, and; (ii) bilateral lines of credit. Although participants generally use only a portion of their liquidity in the payment system[24], these mechanisms have certain limitations. The BCE calculates that participants' contributions to the Liquidity Fund currently cover several times their maximum exposure in the payment system. That said, as contributions are pooled across different facilities, in extreme circumstances, funds may be (partially) unavailable when required by the payment system. The Fund's governance and regulation are distinct and separate from the governance and regulation of the SCP.

[23] Please refer to the WB's TN on "Payments and Financial Market Infrastructures".
[24] SPI participants can avail balances in reserve requirements, where applicable, up to the full amount. As of 2023, only banks, COAC segments 1, 2 and mutualists are subject to reserve requirements.

The risks posed by participants that are not eligible for the Liquidity Fund (smaller cooperatives) are expected to be covered through bilateral lines of credit and restrictions to send transactions. In practice, these mechanisms have not prevented unwinding (one case thus far in 2023). Alongside SPI and other DNS systems, the BCE operates a real-time gross settlement service (SPL) with limited functionality; despite its limitations, transaction values have increased.

**71. The planned rollout of real-time gross settlement across the SCP, while mitigating credit risk, will pose larger liquidity demands on participants without a clear plan to meet these demands.** At the time of the FSAP, the BCE has begun the implementation of a fully-fledged real-time gross settlement (RTGS) system but has not adopted the system rules. In the absence of a central bank intraday liquidity facility and an active interbank repo market, the provision of tools and incentives to manage liquidity efficiently will be even more critical. Ultimately, the possibility to allow the BCE to provide liquidity to payment system participants against high-quality collateral, such as short-term government securities, should be analyzed in the context of the RTGS implementation and would require a legal amendment (to art. 56 par. 3 of the COMyF). As the new system is based on ISO 20022, the BCE plans on managing the transition by running legacy systems in parallel, which could be inefficient, complex and would leave the system as a whole exposed to credit risk.

**72. Despite recent improvements, the securities custody, clearing and settlement infrastructure is not robust enough to instill confidence and enable the expansion of service offerings.** There are two CSDs-SSSs: the BCE-operated DCV, which serves as the only CSD-SSS for government securities, and DECEVALE, owned by the stock exchanges and other shareholders, which serves as the main CSD-SSS for private securities. CSD-SSS operations and risk management practices are not comprehensive or aligned with international standards. DECEVALE, which was intervened in connection with the ISSPOL fraud,[25] may face a sudden deterioration of its general business risk as a result of legal proceedings and reputational effects. This calls for developing appropriate recovery and orderly wind-down plans. Both CSDs report mitigating counterparty risk by adopting a delivery versus payment (DvP) model 2 and requiring that positions are fully funded prior to clearing and settlement. However, there is no integration between CSD-SSSs and the payment system, resulting in delays in the crediting of funds and inefficiencies.

**73. The retail payments ecosystem is characterized by horizontal and vertical integration and lack of full interoperability; retail payment system governance arrangements should be reviewed.** Two initiatives to develop interoperable mobile wallets were not successful, leading bank-owned Banred and cooperative-owned Conecta/RTC to spearhead two fast payment initiatives in the country. Despite its current limitations (e.g., limited transaction channels and use cases, cumbersome user experience), *Pago Directo,* a real-time funds transfer service operated by *Banred*, accounted for 52 percent of 2022 interbank transaction volumes. In this context, the BCE is also considering the possibility to launch a fast payment system. However, the lack of clarity regarding the roles of the public and private sector, a collaboration framework and overarching vision may undermine the successful implementation of fast payments in Ecuador. The cards market is concentrated in the

[25] See Resolución No. SCVS-INMV-DNFCDN-2020-00520 of 18 September 2020.

largest banks, both on the issuing side and acquiring side. ATM networks are interconnected through Banred, and POS networks are largely interoperable.[26] Regulation enables non-banks to provide merchant aggregation and online gateway services, while acquiring remains the banks' prerogative. The interchange fee model is perceived to stifle acceptance. The government recently lifted the obligation on acquirers and aggregators to act as withholding agents for income tax and value added tax for smaller merchants. Social transfer programs and international remittances are mainly disbursed in cash, and would benefit from the participation of new entrants.

**74. Regulation, oversight and supervision struggle to keep pace with retail payment market developments; gaps and overlaps between authorities should be addressed; adequate powers and resources as well as effective cooperation ensured**. Similar payment and settlement activities may qualify and require authorization as: (i) auxiliary services of the financial sector (under the purview of the JPRF and SB); (ii) auxiliary services of the solidarity economy sector (under the purview of the JPRF and SEPS); and (iii) ancillary payment systems/payment services (under the purview of the JPRM and BCE). In addition to a cumbersome process and duplication of efforts in a context of limited resources, the concept of payment systems/services as "auxiliary" service providers to banks/financial institutions is at odds with the entrance of fintechs and should be revised. The Fintech Law amplifies coordination issues, insofar as it casts a very wide net on innovative technologies and business models and does not draw clear boundaries between authorities' responsibilities. For the first time, the Fintech Law of 2022 provides the legal basis for non-bank electronic deposits though it does not comprehensively address innovative payment services (e.g., payment initiation). By prohibiting financial institutions to participate in the capital of fintech companies by any measure, the Fintech Law may have adverse effects on the growth of the fintech sector; other measures could be considered to mitigate distortions, such as requirements on governance arrangements, conflict-of-interest management, and access rules to services and data. Regulators could adopt a phased approach to implementing the Fintech Law, by prioritizing regulation of electronic deposits and digital credit, and leveraging sandbox provisions for other activities to analyze implications on the financial system and inform the regulatory approach accordingly. Authorities could consider integrating open banking in the (mid-term) regulatory agenda. The increasing reliance on information and communications technology will require a careful allocation of powers to financial sector authorities and other state agencies, under a better coordinated approach in the areas of cybersecurity and data protection.

## D. Capital Markets Development[27]

**75. Government debt is sold through private placements and corporate issues are small and concentrated into banks and a few real sector issuers**. The government fixes the interest rates of government securities usually below what market rates could be. Most government securities are placed with the social security system that in practice is a public sector monopoly, while banks holdings reflect mandatory placements by the regulation on liquid assets. Events of default and fraud have damaged the reputation of a rather thin corporate debt market further reducing the already

[26] POS networks are not fully interoperable with respect to card payments in installments.

[27] Please refer to the WB's TN on "Capital Markets Development".

limited activity in the Stock Exchanges. The infrastructure for transacting government and corporate debt faces operational and reputational risks and requires significant upgrades to comply with international standards.

**76. Capital markets in Ecuador have not developed because the critical preconditions for a local bond market to emerge are still lacking.** Recurring external debt defaults, structural macroeconomic imbalances, and the absence of a long-term savings industry are reflected in a strong preference by local investors for holding foreign assets and for domestic assets to be as liquid as possible. The small size and lack of diversification of the financial sector also play a major role in the underdevelopment of the capital market. Even though the pension system allows for a regime of defined contribution complementary to pillar one, the Instituto Ecuatoriano de Seguros Sociales (IESS) is solely responsible for providing for the contingencies of the mandatory general insurance, and the liquidity generated by the contributions of the affiliates is largely recycled into the public sector through purchases of government securities. The lack of diversification is aggravated by financial repression which is evident through the interest caps system and the issuance of government securities at below-market rates.

**77. Market development should be approached as a gradual, long-term endeavor. Nonetheless, the authorities should start building enabling conditions for the capital market to emerge sooner rather than later**. Developing the enabling conditions could help not only the expansion of the capital market but would also contribute to relaxing the barriers posed by macro and demand constraints. Working on providing solid reference risk-free rates and tools for liquidity management by a better functioning market for government securities constitutes the first step. Building conditions to ensure a more regular supply and higher demand of corporate securities should follow but require revising the regulatory framework as well as strengthening the supervision and the financial market infrastructure, notably the CSDs.

**78. Developing the capital market in Ecuador could trigger a larger and better allocation of financial savings that would benefit the government, the financial sector, the corporates and ultimately contribute to faster economic growth**. The development of the capital market could attract a significant volume of savings from offshore, or real estate assets, increasing the pool of financial savings and demand for local securities. A functioning government debt market can assist with the financing of the government through the business cycle. Well-functioning debt and money markets would improve the liquidity of securities held by banks, fostering systemic resilience. Finally, the economy would benefit from a new source for the financing of corporates and productive investments, which are the engine of economic growth and have been declining in Ecuador since the middle of the last decade.

**79. Gradual reforms to build enabling conditions for market development, from building the enablers to having active trading first of government and then non-government securities, may be grouped in three phases.** Efforts would initially focus on building an interest rate reference to the front end of the yield curve by focusing on the short end of government debt market to provide liquidity management tools. Market prices of Cetes and short-term bonds would provide collateral for banks and other investors to start using repos and lay the foundations for a robust money market. At a second stage, the money market would be further developed with special attention to the repos to promote interbank trading of short-term financing in a safe and efficient manner while the MEF continues the price discovery process in medium-term tenors. In parallel, measures to facilitate the supply and increase in demand of corporate paper would be introduced. At a third stage, a market for the corporate debt market would be encouraged to grow in scale and depth. The authorities need to work on broadening the investor base throughout the three phases, as well as on improving the financial market infrastructure and regulation to guarantee the safe and efficient completion of the transactions. A more detailed roadmap is presented in Appendix II.

**80. The challenges for market development in Ecuador are significant and as reforms are implemented, unanticipated obstacles will emerge. This underscores the need for the reform plan to be flexible and be revised as necessary**. As the reform program transitions to the second phase, challenges could emerge with the development of repos (e.g., from the legal, tax regime or CSD angles) that may need to be addressed in a coordinated manner, or with the role played by SOFIs (e.g., revision of BIESS's mandate to focus on fund administration functions). Even in the absence of unexpected hurdles, the scope and sequencing of upstream reforms of phase III will vary depending on the type of financing for the private sector that could be prioritized across different strategic sectors for the economy (e.g., infrastructure, housing, small and medium enterprises).

## E. Green Finance[28]

**81. Green finance markets are at a nascent stage.** The financing needs to meet Ecuador's ambitious climate adaptation and mitigation targets outlined in its Nationally Determined Contribution are likely to exceed the country's fiscal means and will require participation from the private financial sector. However, green finance markets are still at a nascent stage. While several thematic bonds have been issued and some banks offer green loans, volumes are small and the funding has been provided mainly by International Financial Institutions (IFIs) with almost no private investor participation. Developing private green financial markets and instruments will be challenging due to a small domestic institutional investor and clients base, limited awareness of green finance, and the lack of international market access.

**82. Coordination between authorities could be improved by creating a multi-stakeholder platform on green finance.** As with the coordination around climate and environmental risk-related topics, and despite the *National Climate Financing Strategy of Ecuador*, there is currently limited coordination between the financial authorities, ministries and other relevant authorities or market players to engage on relevant green finance topics. Green finance-related initiatives have been pursued in isolation and no regular discussion on strategic priorities or exchange of experiences is taking place. To spur an efficient development of green financial markets and avoid that evolving standards will be fragmented and piecemeal it is recommended to set up a national platform on green finance (for example by activating the dormant *Mesa de Trabajo de Finanzas Sostenibles*) with

[28] Please refer to the WB's TN on "Climate and environmental Risks and Opportunities".

participation of all relevant public and private stakeholders to coordinate and advance development of green financial markets.

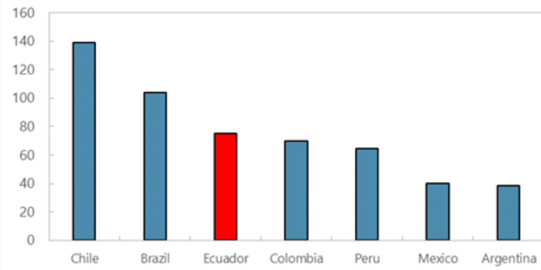
83. **To avoid the risk of 'green washing' and lay the foundations for market development, authorities should develop harmonized definitions and legal frameworks for green products and accelerate work on a green taxonomy.** The absence of clear and harmonized definitions that leaves the classification of green products to the financial institutions themselves makes it difficult for clients, investors, and issuers to determine what constitutes green finance, and for regulators to ensure that green products are meeting environmental objectives. It also poses risks of 'green washing'. Authorities recognize these challenges and have taken initial steps to improve transparency and introduce definitions and standards for green products, most notably through initial work on legal frameworks for thematic bonds and the incipient development of a green taxonomy, which would provide a clear-cut definition of what is considered green. These activities are important and should be swiftly completed. Once finalized, the taxonomy can serve as the needed framework for labeling green finance products and building benchmarks that consider the country's specific context, while aligning with emerging international standards and requirements from IFIs.

84. **Additional incentives for issuers and investors may be needed for developing green finance markets.** Currently, thematic bonds are priced similarly to other instruments, while the issuer faces extra costs for compliance and verification. As there is no 'greenium', i.e. discount that investors grant to account for the environmental and climate benefits of such instruments, financial incentives may be needed to spur issuance. Such an incentive could, for example, come from lower taxation or listing fees. Ecuador's domestic institutional investor base is small but there are some institutions with the capabilities and experience to invest in domestic capital markets. Authorities may want to assess the role that public funds, such as BIESS, and insurance companies can play as investors for green and other thematic bonds. To entice investments, tax or other incentives for potential investors may be contemplated.

## Figure 1. Ecuador: Financial Sector Structure

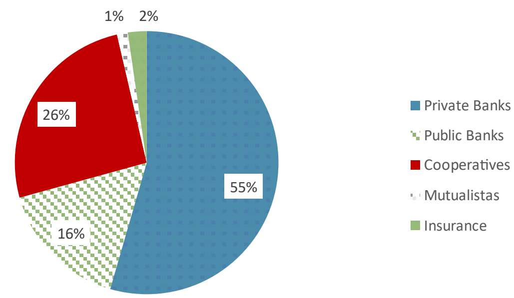
*Ecuador's financial system is moderate is size relative to the economy and is in line with the region.*

**Deposit-taking Sector Assets, September 2022**
**(In percent of nominal GDP)**



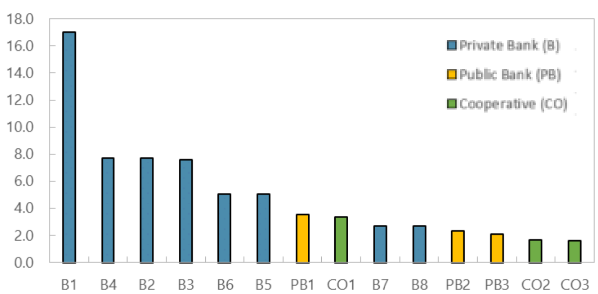

*Banks and cooperatives dominate the system, and there is a substantial participation of state-owned institutions.*

**Deposit Takers' Total Assets, December 2022**



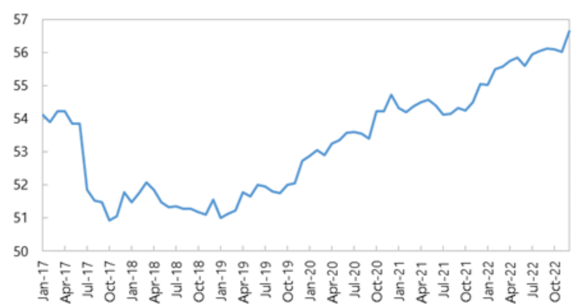

*The cooperative sector has become increasingly important over the last decade and the largest cooperatives compete with banks.*

**Large Financial Institutions Total Assets, December 2022**
**(In percent of financial system assets)**



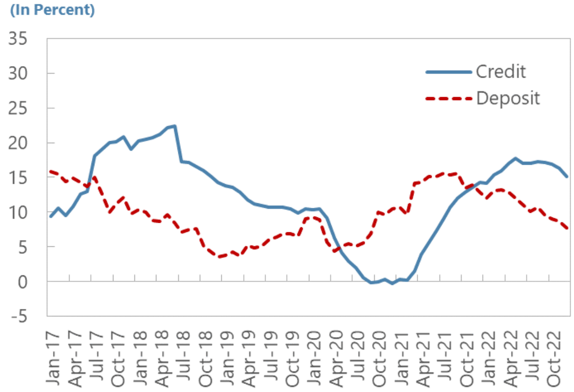

*The 4 largest banks represent about 56 percent of deposit takers assets and bank concentration is increasing.*

**Four Largest Private Banks Assets, 2017-22**
**(In percent of banking system assets)**



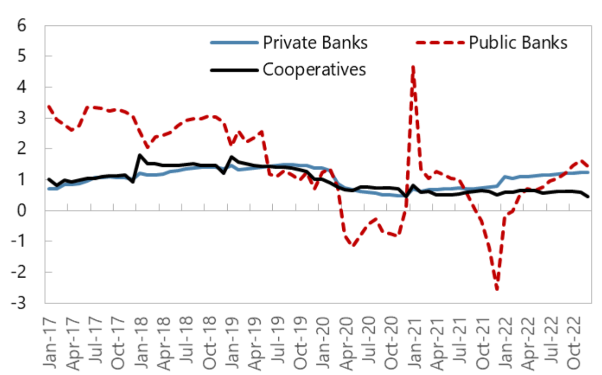
*Lending to the private sector has expanded significantly in recent years, and credit is growing at a faster pace than deposits.*

**Financial System's Credit and Deposit YoY Growth, 2017-22**
**(In Percent)**




*The pandemic impacted profitability, especially for public banks, which also posted losses to reflect the results of AQRs. The recovery of cooperatives's ROA is lagging 2/.*

**Return on Assets, 2017-22**
**(In percent)**

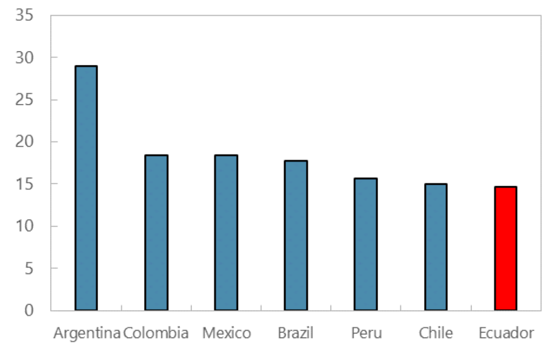



Sources: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria and staff calculations.
1/ Brazil data is as of 2021:Q3; Chile data as of 2021:M12; Mexico data as of 2021:M5
2/ Public banks data does not include Banco del Pacifico or BIESS

## Figure 2. Ecuador: Financial Soundness Indicators

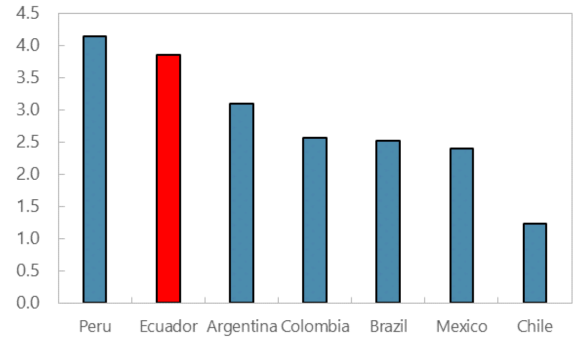
*While the aggregate capital ratio is above 15 percent, it is below other countries in the region.*

**Capital Adequacy Ratio, September 2022**
**(In percent)**



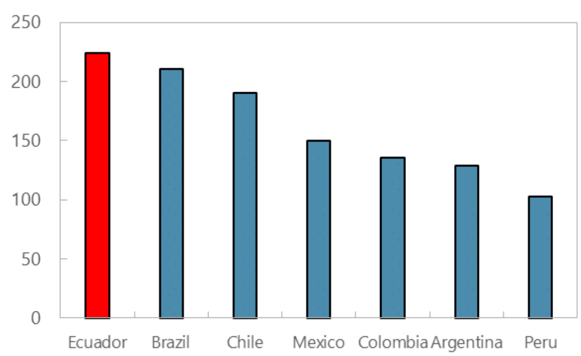

*NPLs are comparable to other countries in the region…*

**Non-performing Loans, September 2022**
**(In percent of gross loans)**



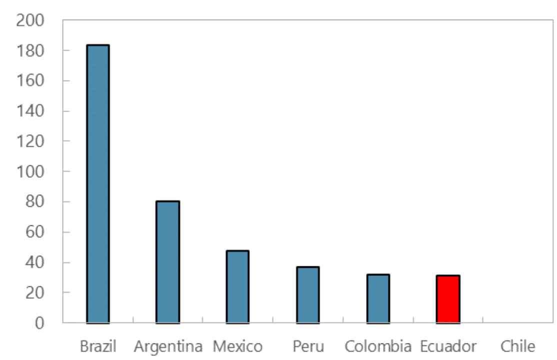

*…and loan loss provisioning levels are comfortable.*[1]

**Loan Loss Provisions, September 2022**
**(In percent of non-performing loans)**



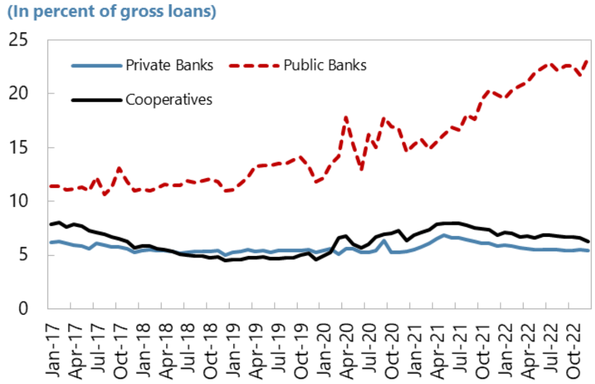

*But liquity indicators appear somewhat weaker…*

**Liquid Assets , September 2022 3/**
**(In percent of short-term deposits)**



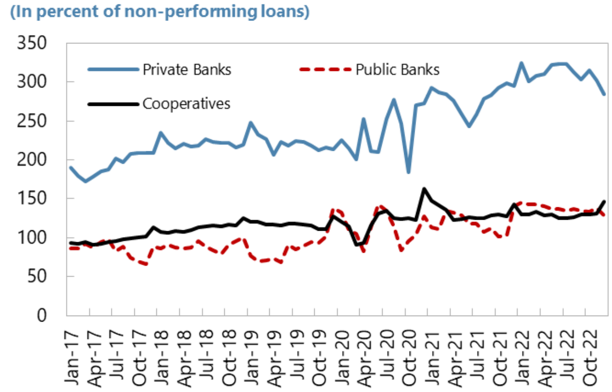

*…and supporting measures encouraged a large amount of restructured loans, particularly in public banks.*

**Augmented Non-performing Loans, 2017-22**
**(In percent of gross loans)**




*Public banks and credit cooperatives have substantially lower loan loss provisions.*

**Loan Loss Provisions, 2017-22**
**(In percent of non-performing loans)**

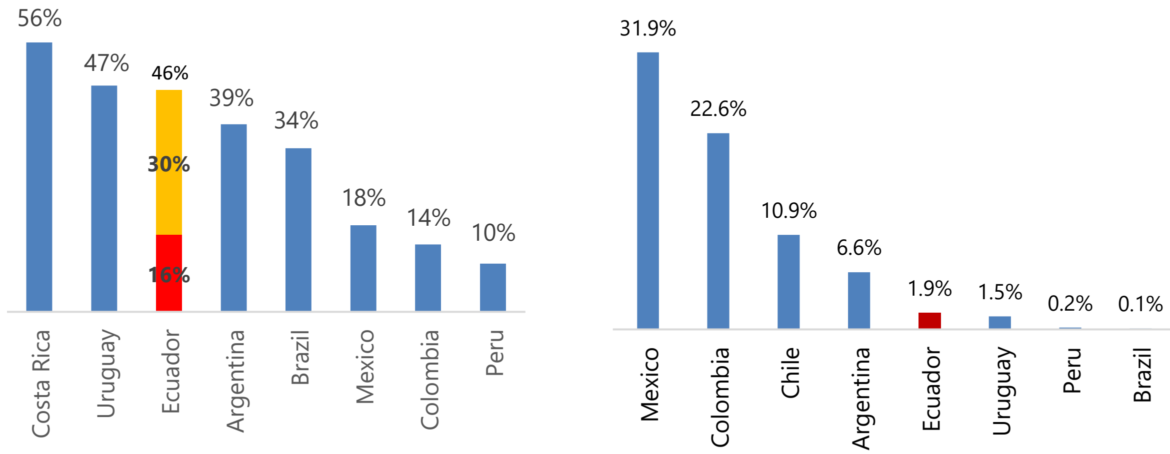



Sources: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria and staff calculations.
1/ Loan loss provision requirements are specific provisions mostly determined by the number of past due days.
2/ (For chart 1-4): Brazil data is as of 2021: Q3; Chile data as of 2021:M12; Mexico data as of 2021:M5
3/ Data for Chile unavailable.

## Figure 3. State-Owned Financial Institutions in Latin America

**State-Owned bank assets as a share of total banking assets (2022)**

**Credit to SMEs covered by PCGs as share to total credit to SMEs (2019)**



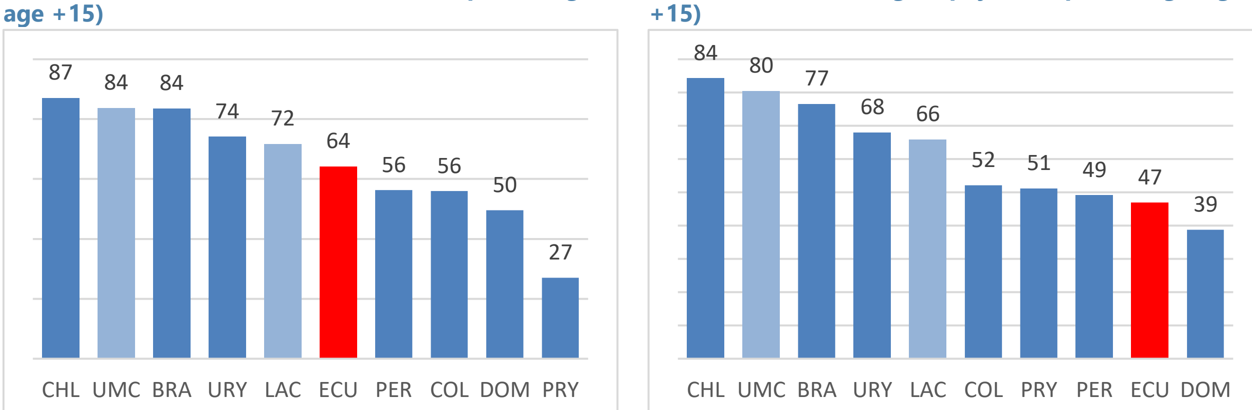

Sources: National Supervisory Agencies; *Challenges of PCG Schemes in Latin America during the Pandemic* (2022).

Note: **In orange: BIESS**; **In red: 5 SOFIs**.

## Figure 4. Selected Financial Inclusion Metrics

**Access to financial institutions accounts (percentage, age +15)**

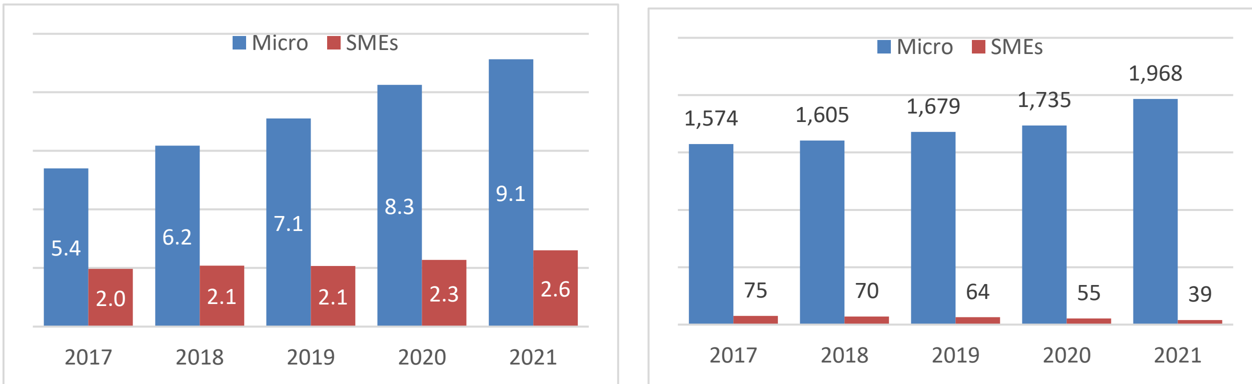
**Made or received a digital payment (percentage, age +15)**




**Source:** Global Findex 2021 data.

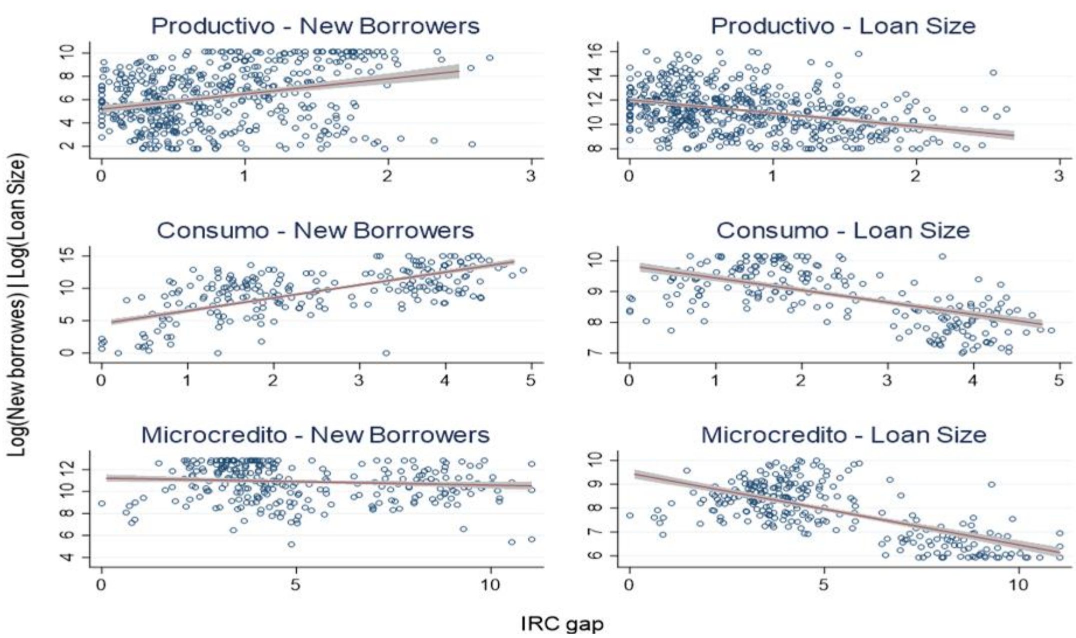
**Figure 5. Micro and SME Credit**

**Micro and SMEs credit (% of GDP)** | **Number of micro and SMEs loans (thousands)**




**Source:** SEPS, SB.

**Figure 6. Correlation between Interest Rate Ceiling Gap, New Borrowers and Loan Size**

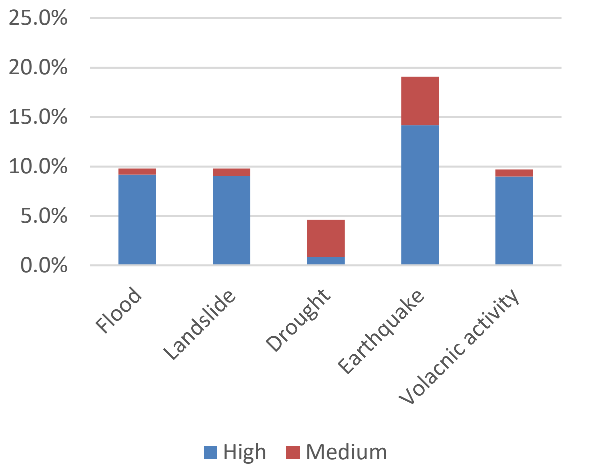



Source: World Bank staff estimates based on SB data.

**Figure 7. Financial Sector Exposure to Climate Physical and Transition Risk.**

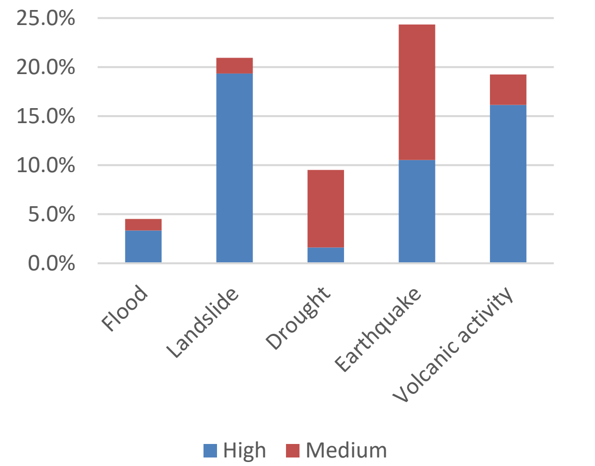
**Bank loans with direct risk exposure to natural hazards***

(% of total bank credit extended in 2022)




**Cooperative loans with direct risk exposure to natural hazards***

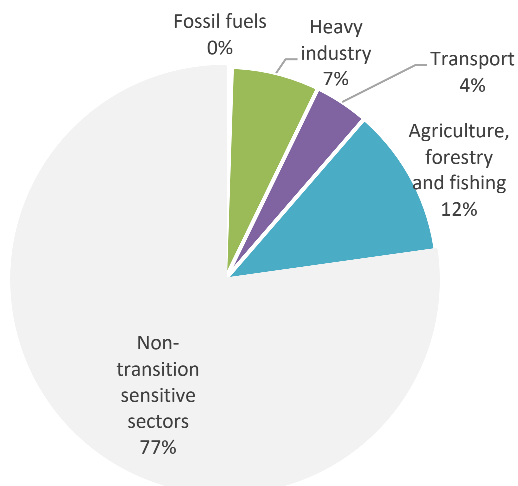
(% of total outstanding cooperative credit end-



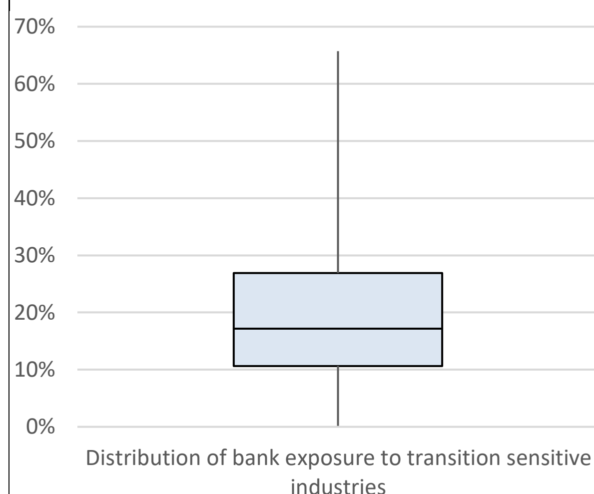

2022)

**Loans to transition sensitive industries****

(% of total bank credit extended in 2022)




**Cross-bank distribution of exposure to transition sensitive industries**




Notes: * The estimates for the share of loans directly exposed to physical risks are obtained by identify sectors that are most directly affected by a certain type of natural hazard and linking them to the canton-level risk classification where these types of loan are located. For banks, these sectors are agriculture (FL, LS, DG, EQ, VA), housing (FL, LS, EQ, VA), transport (FL, LS, EQ, VA), construction (FL, LS, EQ, VA), tourism (FL, LS, EQ, VA) and energy and water (FL, DG). For loans extended by credit cooperatives, exposed loans include only agriculture (FL, LS, DG, EQ, VA), housing (FL, LS, DG, EQ, VA) and transport (FL, LS, DG, EQ, VA) due to data availability and relevance for the sector. The risk classification for each canton is based on data from Thinkhazard. ** Transition sensitive industries are defined based on Calice, et al. (2021) and include Fossil fuels, Energy generation, Heavy industry, Transport and Agriculture, forestry and fishing. Source: Own calculations based on data from SB, SEPS and Thinkhazard.

## Table 3. Ecuador: Selected Economic and Financial Indicators [1/]

| | | | Est. | Projection | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 |
| | *(Percent change, unless otherwise indicated)* | | | | | | | | |
| **National income and prices** | | | | | | | | | |
| Real GDP | -7.8 | 4.2 | 3.0 | 2.9 | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 |
| Domestic demand (contribution to growth) | -10.3 | 7.9 | 5.6 | 1.3 | 2.9 | 2.2 | 2.6 | 2.7 | 2.6 |
| External Demand (contribution to growth) | 2.5 | -3.7 | -2.5 | 1.5 | -0.1 | 0.5 | 0.1 | 0.1 | 0.2 |
| Consumer price index period average | -0.3 | 0.1 | 3.5 | 2.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Consumer price index end-of-period | -0.9 | 1.9 | 3.7 | 2.3 | 1.3 | 1.3 | 1.5 | 1.5 | 1.5 |
| **Banking system** | | | | | | | | | |
| Net domestic assets | 3.6 | 14.9 | 11.0 | 5.6 | 0.9 | 2.0 | 2.9 | 3.2 | 3.8 |
| Liabilities | 12.0 | 12.0 | 9.0 | 6.5 | 4.3 | 3.8 | 3.9 | 3.8 | 3.8 |
| Credit to the private sector | 2.5 | 13.6 | 13.9 | 7.2 | 4.0 | 3.7 | 3.8 | 3.8 | 3.8 |
| **External sector** | | | | | | | | | |
| Exports | -14.2 | 31.0 | 21.1 | -3.2 | 3.3 | 3.4 | 2.2 | 1.5 | 1.2 |
| Oil | -39.5 | 63.9 | 33.3 | -14.9 | 5.9 | -1.9 | -4.1 | -5.0 | -4.5 |
| Non-oil | 8.8 | 21.4 | 13.7 | 3.3 | 2.1 | 5.8 | 4.7 | 3.8 | 3.3 |
| Imports | -23.2 | 43.4 | 24.0 | -3.1 | 3.3 | 2.5 | 1.7 | 1.2 | 1.0 |
| Terms of trade | -5.7 | 1.6 | -4.0 | 0.4 | 0.1 | -0.6 | -1.3 | -1.0 | -0.1 |
| Real effective exchange rate (2010=100) | 120.1 | 114.3 | 109.9 | ... | ... | ... | ... | ... | ... |
| Real effective exchange rate, end-of-period (depreciation,-) | 1.1 | -4.9 | -3.8 | ... | ... | ... | ... | ... | ... |
| | | | | *(Percent of GDP)* | | | | | |
| **Current account balance** | 2.7 | 2.9 | 2.2 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| **NFPS Public finances** | | | | | | | | | |
| Revenue | 29.4 | 34.2 | 36.1 | ... | ... | ... | ... | ... | ... |
| Expenditure | 36.5 | 35.8 | 36.0 | ... | ... | ... | ... | ... | ... |
| Overall balance (deficit -) | -7.1 | -1.6 | 0.1 | ... | ... | ... | ... | ... | ... |
| Public debt 2/ | 60.9 | 62.3 | 57.3 | ... | ... | ... | ... | ... | ... |
| Domestic | 16.2 | 17.6 | 14.9 | ... | ... | ... | ... | ... | ... |
| External | 44.7 | 44.7 | 42.4 | ... | ... | ... | ... | ... | ... |
| | | | | *(Percent of GDP)* | | | | | |
| **Saving-investment balance** | | | | | | | | | |
| Consumption | 75.6 | 76.7 | 75.8 | 76.7 | 75.1 | 74.7 | 74.3 | 74.3 | 74.3 |
| Private | 59.3 | 61.4 | 61.5 | 62.5 | 61.4 | 61.4 | 61.4 | 61.4 | 61.4 |
| Public | 16.4 | 15.3 | 14.4 | 14.2 | 13.7 | 13.3 | 13.0 | 13.0 | 13.0 |
| National saving | 24.8 | 25.2 | 26.0 | 24.9 | 26.5 | 26.7 | 26.9 | 26.9 | 26.9 |
| Private | 26.0 | 20.4 | 20.0 | 18.5 | 19.9 | 20.1 | 20.2 | 20.2 | 20.4 |
| Public | -1.3 | 4.8 | 5.9 | 6.4 | 6.7 | 6.7 | 6.8 | 6.7 | 6.5 |
| Gross investment | 22.0 | 22.3 | 23.7 | 22.9 | 24.5 | 24.7 | 24.9 | 24.9 | 24.9 |
| Private 3/ | 15.4 | 15.1 | 17.1 | 16.3 | 18.0 | 18.2 | 18.3 | 18.3 | 18.3 |
| Public | 6.7 | 7.3 | 6.7 | 6.6 | 6.6 | 6.5 | 6.6 | 6.6 | 6.6 |
| **Memorandum items:** | | | | | | | | | |
| Nominal GDP (US$ millions) | 99,291 | 106,166 | 116,360 | 121,291 | 126,449 | 131,202 | 136,314 | 141,514 | 146,911 |
| GDP per capita (US$) | 5,670 | 5,979 | 6,462 | 6,643 | 6,829 | 6,988 | 7,159 | 7,329 | 7,504 |
| Gross international reserves (US$ millions) 4/ | 7,133 | 7,898 | 8,459 | 9,491 | 11,376 | 12,576 | 13,531 | 14,339 | 14,908 |
| Gross international reserves (as a percent of ARA metric) | 34 | 34.9 | 36.0 | 40.0 | 46.8 | 50.8 | 53.8 | 56.3 | 58 |
| Net international reserves (US$ millions) 5/ | -7,161 | -5,747 | -6,413 | -5,107 | -2,824 | -618 | 1,197 | 2,706 | 3,966 |
| Oil price Ecuador mix (US$ per barrel) | 35.6 | 62.0 | 85.1 | 70.9 | 68.6 | 65.9 | 62.5 | 59.5 | 56.8 |
| Oil production (millions of barrels) | 175.4 | 172.6 | 175.5 | 178.5 | 189.2 | 192.5 | 194.8 | 194.8 | 194.8 |
| Exports of oil (millions of barrels) 6/ | 146.4 | 133.7 | 131.7 | 133.5 | 145.5 | 148.7 | 150.7 | 150.2 | 150.2 |

Sources: Ministry of Economy and Finance; Central Bank of Ecuador; Haver; World Bank Development Indicators; and Fund staff calculations and estimates.
1/ World Economic Outlook (April, 2023). This forecast was closed before data from 2022Q4 was released.
2/ Gross debt consolidated at the level of the NFPS. Includes the outstanding balance for advance oil sales, treasury certificates, central bank loans, other liabilities and the stock of domestic floating debt. The public debt estimates are preliminary and subject to revisions in accordance with the IMF's Public Sector Debt Statistics: Guide for Compilers and Users (PSDSG).
3/ Includes inventories.
4/ GIR excludes non-liquid and encumbered assets.
5/ Net international reserves is equal to gross international reserves less outstanding credit to the IMF, short-term foreign liabilities of the BCE, deposits of other depository institutions and other financial institutions (excl. BIESS) at the central bank, and short-term liabilities of the central government, all derivative positions. Program exchange rates are those in effect on July 31, 2020 (see TMU).
5/ Underlying reserves refers to NIR less outstanding obligations of the treasury to the IMF.
6/ Includes both crude and derivatives.

**Table 4. Ecuador: Structure of Financial System, December 2022 1/**

| Institution | Total Assets | | |
|---|---|---|---|
| | (US$ Mil.) | (In percent of total assets) | (In percent of GDP) 2/ |
| **Private Banks (23)** | **49,895** | **41.8** | **43.0** |
| Large Banks (3) | 29,347 | 24.6 | 25.3 |
| Medium Banks (9) | 18,631 | 15.6 | 16.1 |
| Small Banks (11) | 1,916 | 1.6 | 1.7 |
| **Public Banks (5)** | **14,881** | **12.5** | **12.8** |
| Development banks (4) | 7,891 | 6.6 | 6.8 |
| Commercial bank (1) | 6,991 | 5.9 | 6.0 |
| **Cooperatives (467)** | **23,509** | **19.7** | **20.3** |
| Segment 1 | 19,863 | 16.6 | 17.1 |
| Segment 2 | 1,221 | 1.0 | 1.1 |
| Segment 3 | 2,121 | 1.8 | 1.8 |
| Segment 4 | 1,030 | 0.9 | 0.9 |
| Segment 5 | 439 | 0.4 | 0.4 |
| **Mutualistas (4)** | **1,221** | **1.0** | **1.1** |
| **Total deposit-takers** | **89,506** | **75.0** | **77.1** |
| **BIESS** | **27,806** | **23.3** | **24.0** |
| **Insurers (28)** | **1,221** | **1.0** | **1.1** |
| **Total** | **119,410** | **100** | **103** |

Sources: Central Bank of Ecuador, Superintendencia de Economia Popular y Solidaria, and Superintendencia de Bancos.

1/ Data for Segment 4 and 5 of Cooperatives and Mutualistas as of September 2022. Banco del Pacifico classified as a public commercial bank.

2/ Data for 2022 Nominal GDP from IMF Spring 2023 WEO

## Table 5. Ecuador: Financial Soundness Indicators (2017-22)

(In percent, unless otherwise indicated)

| | Dec-17 | Dec-18 | Dec-19 | Dec-20 | Dec-21 | Dec-22 |
|---|---|---|---|---|---|---|
| **Private banks** | | | | | | |
| Capital adequacy ratio | 13.7 | 13.4 | 13.5 | 14.5 | 13.9 | 13.7 |
| Non-performing loans / gross loans | 3.0 | 2.6 | 2.7 | 2.6 | 2.1 | 2.2 |
| Augmented non-performing loans / gross loans | 5.3 | 5.0 | 5.2 | 5.3 | 5.8 | 5.4 |
| Provision / non-performing loans | 234.4 | 247.7 | 225.6 | 293.1 | 324.4 | 314.0 |
| Liquid assets / short-term deposits | 29.4 | 27.9 | 26.0 | 34.1 | 28.6 | 28.9 |
| Gross loans (billions of US dollars) | 24.6 | 27.3 | 30.0 | 29.5 | 33.7 | 38.6 |
| Gross loans / (demand deposits and time deposits) | 83.8 | 91.6 | 93.4 | 81.7 | 84.5 | 91.7 |
| Return on assets | 1.0 | 1.4 | 1.4 | 0.5 | 0.8 | 1.2 |
| Return on equity | 10.4 | 13.6 | 13.9 | 4.8 | 7.6 | 12.2 |
| Total credit (billions of US dollars) | 24.6 | 27.3 | 30.0 | 29.5 | 33.7 | 38.6 |
| Total credit growth (yoy) | 20.7 | 11.1 | 9.9 | -1.6 | 14.0 | 14.6 |
| Total deposits (billions of US dollars) | 30.7 | 31.3 | 33.7 | 37.5 | 41.2 | 43.6 |
| Total deposit growth (yoy) | 7.0 | 1.9 | 7.7 | 11.4 | 9.8 | 5.9 |
| Total equity (billions of US dollars) | 4.2 | 4.6 | 5.0 | 5.1 | 5.5 | 6.0 |
| Total equity growth (yoy) | 17.8 | 9.3 | 9.4 | 0.9 | 8.0 | 9.9 |
| **Public banks** | | | | | | |
| Capital adequacy ratio | 39.7 | 37.5 | 36.8 | 35.2 | 31.7 | 33.3 |
| Non-performing loans / gross loans | 5.4 | 4.9 | 5.7 | 9.6 | 15.3 | 16.8 |
| Augmented non-performing loans / gross loans | 10.9 | 11.0 | 11.8 | 14.6 | 19.8 | 23.4 |
| Provision / non-performing loans | 88.5 | 100.2 | 137.7 | 127.6 | 140.1 | 128.4 |
| Liquid assets / short-term deposits | 34.5 | 25.7 | 19.8 | 40.3 | 52.2 | 43.9 |
| Gross loans (billions of US dollars) | 4.2 | 4.7 | 5.0 | 4.9 | 4.6 | 4.5 |
| Gross loans / (demand deposits and time deposits) | 105.6 | 124.0 | 130.2 | 132.1 | 126.9 | 136.2 |
| Return on assets | 3.1 | 2.9 | 0.7 | 0.1 | -2.6 | 1.5 |
| Return on equity | 9.6 | 8.8 | 2.1 | 0.3 | -7.5 | 4.4 |
| Total credit (billions of US dollars) | 4.2 | 4.7 | 5.0 | 4.9 | 4.6 | 4.5 |
| Total credit growth (yoy) | 8.4 | 10.6 | 7.6 | -2.8 | -4.9 | -2.1 |
| Total deposits (billions of US dollars) | 4.0 | 3.8 | 3.9 | 3.7 | 3.7 | 3.4 |
| Total deposit growth (yoy) | 8.2 | -5.7 | 2.5 | -4.2 | -0.9 | -8.7 |
| Total equity (billions of US dollars) | 2.7 | 2.8 | 2.8 | 2.7 | 2.3 | 2.5 |
| Total equity growth (yoy) | 10.3 | 6.3 | 0.4 | -4.3 | -15.7 | 8.6 |
| **Cooperatives (Segment 1-3)** | | | | | | |
| Capital adequacy ratio (Segment 1 only) | 18.0 | 16.9 | 17.0 | 17.2 | 17.3 | 15.7 |
| Non-performing loans / gross loans | 5.0 | 3.9 | 3.9 | 3.8 | 4.2 | 4.0 |
| Augmented non-performing loans / gross loans | 7.1 | 5.2 | 4.8 | 6.3 | 7.5 | 6.8 |
| Provision / non-performing loans | 113.1 | 125.4 | 127.5 | 162.4 | 142.9 | 146.3 |
| Liquid assets / short-term deposits | 25.1 | 21.3 | 24.4 | 30.0 | 28.5 | 24.5 |
| Gross loans (billions of US dollars) | 7.5 | 9.5 | 10.8 | 11.3 | 14.0 | 17.1 |
| Gross loans / (demand deposits and time deposits) | 89.9 | 100.2 | 98.3 | 91.5 | 89.7 | 93.9 |
| Return on assets | 6.9 | 8.8 | 7.5 | 3.4 | 4.1 | 3.5 |
| Return on equity | 0.9 | 1.2 | 1.0 | 0.5 | 0.5 | 0.4 |
| Total credit (billions of US dollars) | 7.5 | 9.5 | 10.8 | 11.3 | 14.0 | 17.1 |
| Total credit growth (yoy) | 7.5 | 9.5 | 10.8 | 11.3 | 14.0 | 17.1 |
| Total deposits (billions of US dollars) | 8.5 | 9.7 | 11.2 | 12.6 | 15.8 | 18.5 |
| Total deposit growth (yoy) | 21.9 | 14.2 | 15.6 | 12.5 | 25.9 | 16.4 |
| Total equity (billions of US dollars) | 1.6 | 1.9 | 2.1 | 2.3 | 2.6 | 2.9 |
| Total equity growth (yoy) | 15.7 | 18.5 | 13.4 | 6.7 | 14.3 | 13.7 |

Source: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria and Fund staff calculations.

## Appendix I. Ecuador: Implementation Status of Key Recommendations from the 2004 FSAP as of December 2022

| Main Recommendations | Implementation Status | Action Taken/ Comments |
| --- | --- | --- |
| **Short-term** | | |
| Strengthen bank supervision by introducing: (i) strict adherence to International Accounting Standards; (ii) supervisory training; (iii) legal provisions to guarantee the political independence of the SBS and the legal protection of bank supervisors while performing their duties; (iv) a system for the evaluation of major acquisitions and investments along with fit and proper tests; (v) effective consolidated supervision including off-shore banks; (vi) adequate monitoring of liquid assets held abroad by banks; and (vii) licensed cooperatives, supervised by the SBS, acting as wholesale institutions that can facilitate delegated supervision of the cooperatives currently supervised by the Ministry of Social Welfare (MBS). | **Partially implemented** | Identified gaps presented in the financial sector oversight section include *inter alia*: supervisory training needs, constraints to banking supervisory independence, and the supervision of large cooperatives. |
| Eliminate regulatory forbearance by (i) enforcing bank loan classification based on information provided by the Credit Registry and requiring higher provisions and capital when necessary; (ii) requiring additional provisions from cooperatives, savings and loans and finance companies under the SBS while monitoring their asset growth and capital adequacy carefully. | **Partially implemented** | See financial sector oversight section on harmonization of capital, loan classification and provisions, and liquidity requirements of cooperatives with that of banks. |
| Remove ceilings to interest rates (usury rate). | **Partially implemented** | A methodology to calculate maximum rates based on average bank costs was developed by BCE and established in the regulation in 2021. As of June 2023, JPRF is not using the methodology to set rate ceilings. |
| Sell Banco Pacífico at market price. If necessary, the BCE might need to undertake responsibility for any contingent liability. Liquidate all closed banks by end-2004. | **Not implemented** | Banco del Pacífico remains a state-owned bank, as an attempt to sell it in 2022 was unsuccessful. Prolonged liquidation process ongoing for Banco Nacional de Fomento and Banco Ecuatoriano de la Vivienda. |
| Strengthen the resilience of less capitalized banks to systemic shocks by gradually raising minimum capital requirements to 11 percent over three years | **Not implemented** | Minimum capital requirements are 9 percent of risk-weighted assets, with no Pillar 2 capital requirements. |
| **Main Recommendations** | **Implementation Status** | **Action Taken/ Comments** |
| Set up a new Liquidity Fund as soon as the contingent credit line from the Latin American Reserve Fund (FLAR) becomes available. | **Implemented** | Liquidity Fund established, managed by COSEDE (the deposit insurance corporation) |

| | | |
|---|---|---|
| Set up a new deposit insurance agency. Give transitory powers to the AGD to complete the pending liquidation process, without further access to new bank contributions. | **Implemented** | COSEDE is responsible for deposit insurance and the management of the Liquidity Fund |
| Improve the efficiency of the payment system by (i) improving the legal framework and clearly defining the BCE's responsibilities as manager of the payment system; (ii) avoiding the simultaneous presence of both gross and net systems for large value transactions settlement. | **Partially implemented** | COMyF entrusts the BCE with the operation of the central payment system. There is no dedicated system or special procedure for settlement of large-value transactions. No system is formally designated as systemically important. The BCE began implementing a real-time gross settlement (RTGS) system; however, it has not yet developed system rules. |
| Improve the allocation of resources by (i) revising the 2001 reform of the pension system; (ii) implementing the proposed reform of state-owned development banks; (iii) repealing the many regulations that impose a segmentation of the capital markets between Quito and Guayaquil; (iv) imposing international accounting and auditing standards on large non-financial corporations; (v) increasing the liquidity of the government bond market by standardizing new issues. | **Partially implemented** | The implementation of *Sistema Unico Bursatil* contributed to solving the segmentation between BVQ and BVG. There has been little progress on corporate audits and on standardization of government securities. |
| Keep the Bank of the Estate of Ecuador (BEDE) within the limits of its mandate as a bank that lends to and takes deposits from municipalities. | **Implemented** | BDE has continued to lend mostly to local governments and receive funding from funds under administration, deposits at regulated rates and foreign development partners. |
| Strengthen creditor rights and bankruptcy procedures. Introduce the necessary legal reforms to make bank exit policies more efficient. | **Not implemented** | Bank resolution regime remains underdeveloped |
| Promote the development of insurance services by (i) introducing a more favorable legal, fiscal, and regulatory framework for insurance companies; (ii) making motor vehicle insurance compulsory. | **Partially implemented** | Insurance sector remains small |
| Formulate a set of explicit guiding objectives for debt management, keep track of the maturity structure and returns of the outstanding debt, and diversify the debt stock across the yield curve. | **Partially implemented** | The authorities have received multilateral and bilateral Technical Assistance towards the development of a Medium-Term Debt Management Strategy. |

## Appendix II. Ecuador: Phases to build enabling conditions for capital market development

This Appendix presents a tentative roadmap for the development of enabling conditions for capital markets, as discussed in Section V-D.

### Phase I

**Phase I is the start of a process in which the MEF will move to a market-based system in the supply of government securities**. The potential development of the entire capital market stands on the functioning of the government debt market which at present remains muted due to financial repression. Because the move is complex and costly, we suggest starting with discount instruments (Treasury Notes and, if possible, Cetes) in Phase I. Auctions would permit discovering short-term risk-free rates, which would enable the financial system to better manage liquidity and provide useful collateral for the use of repos.

**Auctioning discount instruments requires detailed planning, the adoption of an appropriate infrastructure, and careful analysis of the demand**. MEF needs to select few key tenors, for instance one, three and six months, organize issue and maturity dates, define the frequency and issue sizes in line with an issuance program, adopt an electronic platform and revise the legal framework imposing regulatory hurdles that hinder the participation of banks and other agents.

**To address the weaknesses in the risk management and governance framework of DCV, BCE should finalize the assessment of the FMI based on IOSCO principles**. The assessment together with the audit of the Securities and Settlement Systems (SSS) should systematically capture the key weaknesses of the current infrastructure, including the functioning of the clearing and settlement systems, and provide a robust base for addressing outstanding issues of concern. Ideally this assessment should be completed before BCE transition to a RTGS and the connection of the payment system with the SSS. The plans to strengthen Ecuador FMI should include developing appropriate recovery and orderly wind-down plans for DECEVALE.

**To prepare for the increase in the supply of corporate paper, SCVS capacity in the processing of public offerings and the supervision of credit ratings should be strengthened**. SCVS should seek technical assistance directed at assessing its institutional capacity to fulfill its broad responsibilities as supervisor of the securities market following international standards. The suggested assistance should foster market confidence in SCVS capacity and enforcement, as well as trust in credit ratings.

**The demand for non-corporate government debt has been affected by events of fraud and default that reflect weak supervision and oversight.** To protect investors against these recurring events, SCVS needs to significantly improve the quality assessment of the prospectuses and the monitoring of the issuers and in particular to ensure that at all times the ratings do reflect the true financial health of the issuer. In addition, for all investors -especially for the non-residents- it is essential that the regulation of the custodial activity and the capital requirements for custodians are in line with international sound practice. Under the current conditions, non-residents will find it extremely challenging entering the Ecuador capital market even if rates and currency are attractive.

### Phase II

**Phase II contemplates the promotion of repos to continue the build-up of the money market.** With market prices for Cetes and now T-Bonds, there would be more collateral available for repos. In Phase II the authorities should ensure that the current legal framework, regulation, accounting, tax regime and the CSDs are all aligned to provide a safe and efficient ecosystem for transacting repos. To help jumpstart the repo market we suggest the use of an electronic platform administered by BCE or by the Stock Exchange. The administrator of the platform would not be a counterpart in the transactions. A key objective is for the repos to revive interbank trading and help alleviate the current liquidity constraints faced by the banking sector.

**The authorities should take the required regulatory steps to clarify the authorization for BIESS and other SOFIs to transact repos**. BIESS and CFN have been stopped from transacting repos by the Comptroller; these restrictions should be lifted. SOFIs holding of government securities are large and can become effective vehicles for raising liquidity if need be. Unblocking the stock of government securities sleeping in the SOFIs portfolios can contribute to a more dynamic market, better price discovery and better liquid management in the system.

**In Phase II MEF would continue moving towards a market-based system by auctioning T-Bonds**. The auctioning of T-Bonds should be preceded by the approval of re-openings, essential for the buildup of benchmark securities. To accelerate the buildup of benchmark bonds and the development of the secondary market, the issuance program could be supplemented with liability management operations (LMOs) conducted with BIESS and other bond holders.

**The activation of a market for Cetes and short-term bonds and repos should be an opportunity to promote the issuance of commercial paper by banks and cooperatives.** The reforms to the SML carried out in 2014 eliminated the possibility for banks to issue short-term debt. Revising the SML to authorize banks to issue commercial paper will inject activity to the market that should respond in a positive manner to the MEF moving into a market-based system with the Cetes.

**To incentivize the demand for corporate paper the authorities should relax the current constraints to the growth of Investment Funds and promote their participation in the money market.** The legal framework should be revised to clarify the current ambiguity regarding the authorization to banks and cooperatives to invest in Investment Funds; raise or eliminate the cap on the ratio of managed funds to the equity of the fund manager; and allow financial entities to distribute products offered by Investment Funds.

**To continue expanding the supply of corporate paper, the Stock Exchange should promote the use of corporate debt among large and medium size firms and SCVS should streamline the approval process**. A large number of potential corporate debt issuers seem to not use the securities market due to the lack of awareness of opportunities or because the process is too burdensome. Targeted marketing to the companies that may benefit from market access and an efficient and agile approval process could be attractive incentives to increase the supply of corporate paper.

**Demand can also grow if BIESS's mandate refocuses on managing the social security funds and if it is allowed to use private fund administrators to improve the return of its assets under management.** Clarifying BIESS mandate to maximize the return on the assets under management would help BIESS specialize in the fund management business. The realignment of its mandate could be complemented with allowing BIESS to allocate resources to different fund administrators based on performance. This would benefit IESS affiliates and support market development.[29]

**As a secondary market starts emerging, the JPRF should provide appropriate regulation to ensure adequate post-trade transparency.** Regulation should establish sound reporting and valuation practices so that investors have full information on where the market is. Supported by the technical assistance in Phase I, the SCVS should develop the technical capacity to design mechanisms to assess and enforce the compliance with the new regulation aligned to international standards, together with improved supervision of public offerings and rating agencies.

**To address the management of the corporate debt defaults, the authorities may seek technical assistance to review the commercial insolvency regimes**. The assistance would be directed at improving debt recovery and facilitating business exit. An alternative is to request an Insolvency and Creditor Rights ROSC to evaluate the strength of a country's laws and institutions in that regard (see also Section IV-B).

**Finally, supported by the assessment conducted in Phase I, the authorities should continue the strengthening of the FMI**. Based on the FMI assessment, BCE should upgrade the CSD to ensure straight-through-processing, integrate it with the payment system and develop a collateral management function, while strengthening risk-management governance. The two CSDs should also be linked. The upgrade will bring CSD-SSS operations and risk management practices in line with international standards.

### Phase III

**Phase III focuses on broadening and deepening the non-government securities market**. Building on the development of government debt and money markets achieved in phase II, phase III dedicates to significantly increase the scale of issuance of fixed-income securities in the medium and long-term sector. At present, the corporate sector does have access to these instruments but because the lack of enabling conditions referred to above their utilization is relatively small and available only to a handful of large companies that have also access to foreign lines of credit.

**To broaden the investor base, Ecuador should facilitate channels for nonresidents to access the local market.** Regulatory and tax barriers could be lifted to allow nonresidents to access the government and corporate debt market. Nonresidents would also require a robust market infrastructure implying a significant upgrade of both CSDs and most likely a bridge with an international clearing settlement and depository. If the infrastructure is adequate, the level of interest rates in Ecuador should attract interest from investors from abroad, bringing a boost to demand and a much-needed diversification to the investor base.

**A separate consideration for Phase III is the potential broadening of the institutional investor base by allowing the emergence of privately administered complementary saving plans in a proposed pension reform.** The reforms recently presented by the Interdisciplinary Commission for the Reform of the Pension

[29] Please refer to the WB's TN on "The Role of the State in the Provision of Financial Services".

System[30] could greatly benefit the demand for government securities through the strengthening the governance arrangements for the management of the social security funds, the development of complementary saving plans that would be administered by private asset managers and the separation of back-office functions from the investment management. This pension reform has the potential to enlarge the breadth and depth of the financial sector which today is one of the major stumbling blocks to the development of the capital market.

[30] See "Informe de Recomendaciones, Comisión Interdisciplinaria de Reforma al Sistema de Pensiones, Agosto 2023" https://jubilacionsegura.ec/wp-content/uploads/2023/08/Comision-Reforma-Sistema-de-Pensiones_Informe-Recomendaciones.pdf