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PERU

FINANCIAL SECTOR STABILITY ASSESSMENT

July 2018

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PERU

FINANCIAL SYSTEM STABILITY ASSESSMENT

June 15, 2018

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Prepared by
Monetary and Capital Markets Department

This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Peru in October–November 2017 and January-February 2018. The FSAP findings were discussed with the authorities during the Article IV consultation mission in May 2018.

- The FSAP team was led by Prasad Ananthakrishnan (IMF) and Luisa Zanforlin (World Bank), and comprised John Kiff (IMF deputy mission chief), Nadeem Karmali (World Bank deputy mission chief), Raphael Espinoza, Dirk Jan Grolleman, Tumer Kapan, Romain Lafarguette, Yen Nian Mooi, Jonathan Pampolina, Pedro Rodriguez, and Felix Vardy (all IMF); John Quill (IMF expert); Maria Teresa Chimienti, Catiana Garcia-Kilroy, Valeria Salomao Garcia, Gonzalo Martinez Torres, and Peter Wrede (all World Bank); and Eduardo Guimaraes Martinez and Alejandro Micco (WB experts). Soledad Martinez Peria, Andrea F. Presbitero, and Lev Ratnovski (all IMF, RES) contributed to an econometric study of the effect of higher bank capital requirements on credit.
- The mission met with the Minister of Finance, the Deputy Minister of Finance, the Governor of the Banco Central de Reserva del Peru (BCRP), the Superintendent of the Superintendencia de Banco y Seguros (SBS), the Superintendent of the Superintendencia del Mercado de Valores (SMV) and other high-ranking public officials, and senior representatives of local and foreign banks, insurance companies, credit rating agencies, auditors, law firms, nonbank payment service providers, Fintech firms, and industry associations.
- FSAPs assess the stability of the financial system, not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance their resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Prasad Ananthakrishnan and John Kiff, with contributions from the members of the FSAP team.

CONTENTS

TABLES

APPENDICES

Glossary

AFP	Administradora de Fondos de Pensiones
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCP	Basel Core Principles
BCRP	Banco Central de Reserva del Perú
CAR	Capital Adequacy Ratio
CC	Coordinating Committee
CD	Certificate of Deposit
D-SIB	Domestic Systemically Important Bank
EDP	Microcredit Institution
ELA	Emergency Liquidity Assistance
FDI	Foreign Direct Investment
FENACREP	Federación de Cooperativas de Ahorro y Crédito
FSAP	Financial Sector Assessment Program
FSD	Fondo de Seguro de Depósitos
FSSA	Financial System Stability Assessment
FX	Foreign Exchange
GaR	Growth-at-Risk
GDP	Gross Domestic Product
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
INDECOPI	El Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual
KR	Capital Requirement
LA6	Argentina, Brazil, Chile, Colombia, Mexico and Peru
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
LGFS	Ley General del Sistema Financiero y del Sistema de Seguro
MEF	Ministerio de Economía y Finanzas
MFI	Microfinance Institution
ML/TF	Money Laundering/Terrorism Financing
MoU	Memorandum of Understanding
NPL	Non-performing Loan
NSFR	Net Stable Funding Ratio
RAM	Risk Assessment Matrix
RWA	Risk Weighted Assets
SBS	Superintendencia de Banca y Seguros del Perú
SMV	Superintendencia del Mercado de Valores
SRR	Special Resolution Regime
USD	U.S. Dollar

EXECUTIVE SUMMARY

Peru's financial system has developed and become more resilient since the previous FSAP in 2011, but some challenges remain. Peru's main vulnerabilities are external, especially related to growth in trading partners (due to reliance on commodity exports), and exchange rate depreciation (due to significant dollarization), which were confirmed by the Growth-at-Risk (GaR) analysis. Peru is also vulnerable to domestic headwinds, related to uncertainty and spillovers from the ongoing *Lava Jato* investigation. The banking sector remains highly concentrated, with the four largest banks accounting for 83 percent of total private banking sector assets. These top four banks are all classified as domestic-systemically important banks (D-SIBs) and hence are subject to elevated supervision. The mission's stress-test analysis showed that the banking system is largely resilient to adverse shocks, largely because of banks' initial strong capital buffers and profitability. In the adverse scenario, all large banks experience credit losses, but initial high capital and profitability help them remain above the minimum regulatory capital adequacy ratio (CAR) threshold of 10 percent, while, for a few small banks, the CARs fall below the regulatory threshold. The overall banking system's profits decline substantially in the adverse scenario, with some banks facing losses, but the aggregate capital shortfall for these banks is modest. The interconnectedness/contagion analysis showed that the joint probability of distress across all banks has fallen since the post-global financial crisis peak level it reached in 2010. However, shocks that affect credit exposures, which are strongly correlated among large banks, have the potential to become systemic events, since the banking system is concentrated.

Policy action is needed to address these remaining challenges to strengthen financial stability.

- Increasing the risk weights for foreign currency loans consistent with Basel III requirements would be an important refinement, given the high level of dollarization and its potential risks.

- Countercyclical provisions should be strengthened to help smaller banks, which are more exposed to the macroeconomic cycle, build buffers against potential shocks.

- The capital surcharges for systemic banks should be increased to levels in line with the Basel III framework in order to build further resilience against potential losses, given the high level of concentration and the strong correlation of credit risk among banks.

- The current uncertainty due to the continuing *Lava Jato* corruption investigation makes continued close monitoring of banks' off-balance sheet exposures by the Superintendencia de Banca y Seguros del Perú (SBS) a priority.

- The macroprudential toolkit needs to be continuously reviewed to ensure that the SBS and the Banco Central de Reserva del Peru (BCRP) stand ready—as they have been—with the instruments needed to address potential systemic risks.

Peru's macroprudential framework functions effectively, but can be improved even further. An enhanced mandate to the BCRP and SBS for macroprudential policy would be desirable to foster the willingness and ability to act. Implementing a memorandum of understanding (MoU) to strengthen coordination between the BCRP and SBS would reduce any tendency toward policy inaction, help improve accountability and safeguard the strong institutional norms currently in place. In doing so, it is also important to preserve the institutional independence of the separate policy functions of the BCRP and SBS. New risk-monitoring tools to help assess systemic risks could also be introduced, such as growth-at-risk, systemic risk models, and monitoring of corporate sector vulnerabilities.

The SBS has made significant progress on the implementation of the Basel III regulatory reform agenda. The implemented approaches for the capital and liquidity regulatory framework in Peru aim to achieve the same objectives and broadly equivalent overall capital levels recommended by the Basel framework. The SBS uses a robust supervisory approach and has been moving toward a more risk-based framework for both banks and insurance companies. While the authorities are currently supervising the activities of financial and mixed conglomerates in Peru, it would be important to amend the law to be able to more effectively regulate and supervise these conglomerates on a consolidated basis. Also, the SBS should make enhancements to the supervisory approach to financial conglomerates, and among others to the supervisory group capital adequacy assessment. Extending the supervisory perimeter of the SBS to include unsupervised cooperatives is important to strengthen financial system oversight.

Although the current legal framework provides for interagency cooperation when dealing with certain crisis situations, a high-level coordinating committee should be formed to assist in preparing for and managing a systemic financial crisis. Besides legislative support for a crisis management coordinating committee (CC), a MoU should be entered into between the members of this CC and other relevant entities. It should be based on each authority's statutory duties, elaborate on the role of each authority in crisis management, and set out the expectation of cooperation among them toward the shared goal of financial stability.

Strengthening fixed-income markets while fostering financial stability will be an important part of the development agenda. Developing the repo markets would better facilitate liquidity management. The public debt-management strategy should prioritize issuance around benchmark tenors to deepen fixed-income markets. It would also be important to review the taxation of capital-markets instruments to ensure a level playing field with bank savings products. Improvement in infrastructure and trading facilities should further support market development.

Measures are required to improve the pension system to reduce inequities and enhance social protection. While the authorities are evaluating different alternatives for a long-term strategy to improve the pension system, there is an urgent need to repeal the current law that allows for almost a full lump-sum withdrawal when contributors reach minimum retirement age, and to consider incentives to improve replacement rates, including incentives to increase overall contribution rates, and incentives to purchase fixed-term annuities for workers, and to lower overall costs.

Table 1. Peru: FSAP Key Recommendations	
Recommendations	**Time**
Systemic Risk and Macroprudential Policy	
Increase capital surcharges for systemic banks to levels in line with Basel III framework; increase countercyclical provisioning for smaller banks. (SBS) #24	ST
Enhance the monitoring of off-balance-sheet exposures of banks. (SBS) #24	IT
Increase foreign currency lending risk weights in line with Basel III guidelines. (SBS) #24	ST
Introduce new risk-monitoring tools, such as growth-at-risk, systemic risk analysis, and corporate sector stress testing; give enhanced mandate for macroprudential policy to BCRP and SBS; implement MoU between BCRP and SBS to strengthen coordination. (BCRP, SBS) #29	ST/MT
Financial Sector Oversight	
Banks	
Amend legal framework to grant SBS powers to exercise full consolidated supervision. (SBS) #33	MT
Enhance financial group supervisory and regulatory approach with regard to (1) group governance and risk-management requirements; (2) consolidated capital adequacy and liquidity risk-management assessment; (3) establishing a lead supervisor; and (4) establishing a supervisory group rating. (SBS) #33	ST
Implement requirements for recovery and resolution planning for domestic systemically important banks (D-SIBs), as well as for financial groups. (SBS) #32	MT
Strengthen legal protection of all SBS staff in line with international best practice. Ministerio de Economia y Fianzas (MEF) #30	MT
Strengthen the internal governance and control framework by enhancing the internal audit function, including the establishment of an Internal Audit Committee. (SBS) #32	ST/MT
Finalize the review of the current methodology for the calculation of the additional capital requirements as planned; enhance the activation trigger of the countercyclical buffer, and enhance the systemic and single name risk buffers. (SBS) #31	ST
Insurance	
Implement risk-based supervision for all insurers and brokers. (SBS) #35	ST
Cooperatives	
After passage of law to bring financial cooperatives under supervisory umbrella of SBS, design a deposit-insurance system. (BCRP, MEF, SBS) #37	MT
Crisis Management	
Strengthen crisis preparedness and management arrangements. (MEF, BCRP, SBS, Fondo de Seguro de Depósitos (FSD)) #46	MT
Enhance information-sharing between SBS and FSD. (SBS, FSD) #45	MT
Require payout of most insured deposits within seven working days and provide legal protection to FSD staff/agents. (SBS, MEF) #45	MT
Enhance the Emergency Liquidity Assistance (ELA) framework by specifying eligibility and collateral requirements, and by providing for enhanced supervision, to ensure its effectiveness. (BCRP) #44	ST
Financial Integrity	
Strengthen risk-based Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) supervision, including sanctioning powers over banks and other high-risk reporting entities, focusing on preventive measures for mitigating risks of laundering of proceeds of corruption and drug trafficking. (MEF, SBS) #39, 40	ST/MT
Financial Deepening and Pension reforms	
Deepen repo markets, improve clearing and settlement infrastructure, and prioritize medium- and long-term issuance around benchmark tenors. (BCRP, MEF) #53	ST/MT
Design reforms to improve the private pension system. (MEF) #50	ST/MT
Time frame: IT (Immediate) = less than 1 year; ST (short term) = 1- 3 years; MT (medium term) = 3-5 years.	

FINANCIAL STRUCTURE

1. **The financial system is dominated by banks (Table 2).** The top four banks (two of which are foreign) are classified as D-SIBs and hence are subject to elevated supervision. The remainder of the financial system is dominated by two large financial conglomerates and by the private defined-contribution pension system, comprised of four fund managers within the Administradora de Fondos de Pensiones (AFP), whose investments comprise about 23 percent of total financial-sector assets. A wide range of microfinance institutions (MFIs) also offer financial services, often in rural areas and for the lower-income urban population.

Table 2. Peru: Financial Sector Structure

	Total Assets						***Number of Institutions***	
	Millions of Soles		*In Percent of GDP*		*Percent of Total System Assets*			
	2011	**2017**	**2011**	**2017**	**2011**	**2017**	**2011**	**2017**
Banks	**224,639**	**425,375**	**48.3**	**62.6**	**63.9**	**63.5**	**19**	**21**
Commercial	193,056	371,303	41.5	54.7	54.9	55.5	15	16
-Four Largest	*160,820*	*309,539*	*34.6*	*45.6*	*45.8*	*46.2*	*4*	*4*
-Foreign-Owned	*92,212*	*181,998*	*19.8*	*26.8*	*26.2*	*27.2*	*11*	*12*
Investment		208		0.0		0.0		1
Public sector	31,583	53,865	6.8	7.9	9.0	8.0	4	4
Non-Banks								
Pension Funds	81,881	156,247	17.6	23.0	23.3	23.3	4	4
Insurers	19,786	45,146	4.3	6.6	5.6	6.7	14	21
Non-bank MFIs	16,345	28,218	3.5	4.2	4.7	4.2	35	28
Finance companies	7,735	13,328	1.7	2.0	2.2	2.0	10	11
Others	954	1,162	0.2	0.2	0.3	0.2	19	18
Total	**351,340**	**669,476**	**75.6**	**98.6**	**100.0**	**100.0**	**101**	**103**

Financial Markets (Outstanding Securities in Millions of Soles)

	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Stock Market	327,823	391,181	337,226	360,840	309,004	416,167	526,354
- Percent of GDP	*70.5*	*78.5*	*63.1*	*62.6*	*50.4*	*63.1*	*77.5*
Government Debt	31,244	35,622	40,585	51,956	61,189	77,165	100,661
- Percent of GDP	*6.7*	*7.1*	*7.6*	*9.0*	*10.0*	*11.7*	*14.8*
Corporate Debt	17,372	17,424	18,174	18,321	21,650	23,387	24,728
- Percent of GDP	*3.7*	*3.5*	*3.4*	*3.2*	*3.5*	*3.5*	*3.6*

Sources: BCRP; SBS; BIS Debt Securities Statistics and IMF staff estimates.

2. Domestic capital markets remain shallow and illiquid. Despite an increase in the number of listed companies over the past decade, the local stock market's capitalization as a share of GDP has increased only marginally, and the turnover ratio has remained mostly unchanged in the past 5 years at around 3.5 percent. Local-currency bond markets in government and private-sector securities remain subdued despite some efforts to increase liquidity. Domestic currency money markets are relatively small, are of short maturity, and are dominated by unsecured interbank transactions. The repo market is at a nascent stage and relies almost uniquely on the certificates of deposit (CDs) issued by the BCRP as underlying instruments. However, this market is still shallow and despite the development of a repo master agreement in 2015, as activity is sporadic, partly due to high transaction and settlement costs.

3. Financial soundness indicators suggest that banks are profitable and well-capitalized with low nonperforming loans (NPLs) and strong provisions (Table 3 and Appendix II). Corporate lending is diversified across industries. Profitability is still high, and return on assets has remained stable at around 2 percent, even in the face of declining commodity prices, exchange-rate depreciation, and the growth slowdowns around 2014 and in late 2016. The Peruvian banking system is also one of the high performers in terms of profitability, among the regional peers (Figure 1).

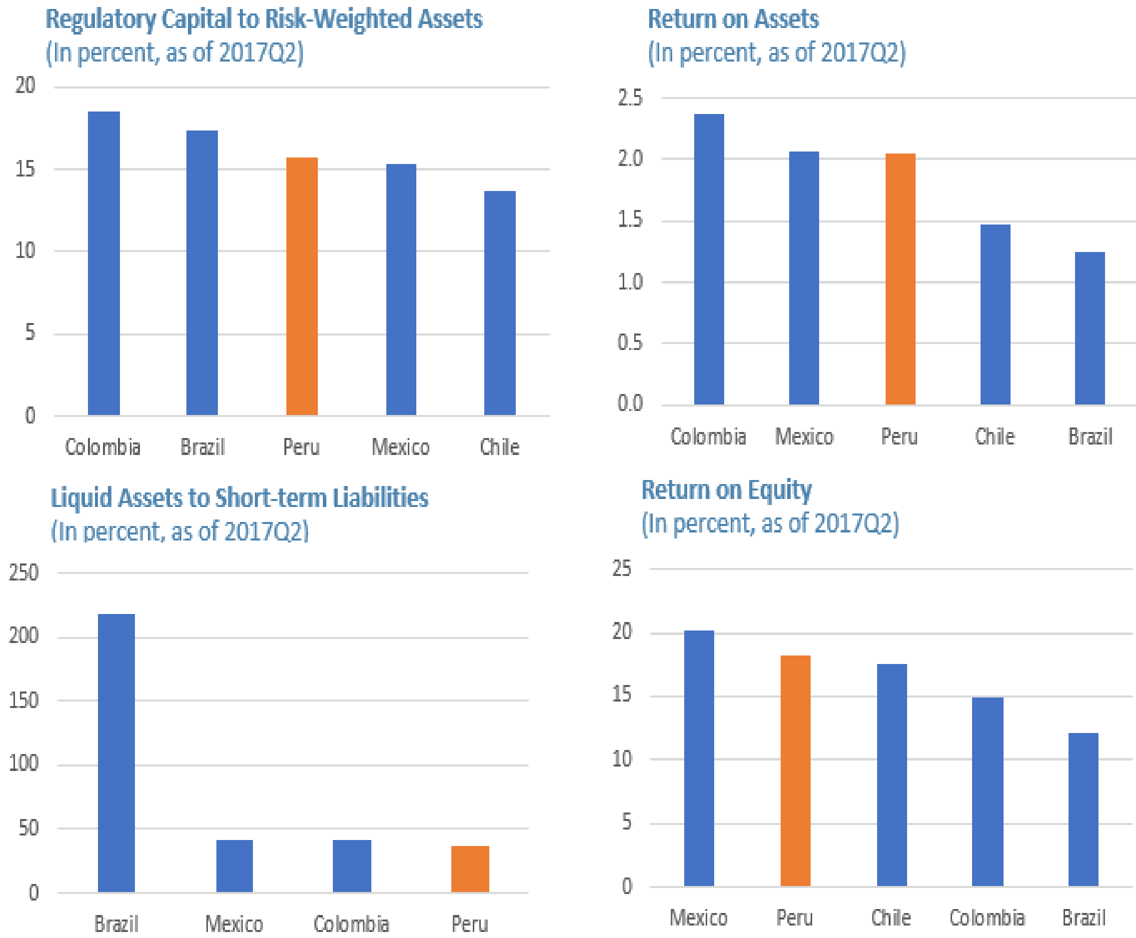
4. Banks hold large volumes of very liquid assets, largely due to the high reserve requirements of BCRP. The (marginal) rate of reserve requirement for foreign-currency liabilities stood at 36 percent at the end of March 2018, and it was as high as 70 percent in December 2016. As a result, more than 17 percent of bank assets are very liquid assets, mostly cash and central bank reserves.

Table 3. Peru: Key Financial Soundness Indicators (Year-end in percent)

	2013	2014	2015	2016	2017
Capital Adequacy					
Regulatory capital to risk-weighted assets	13.9	14.2	14.3	15.1	15.2
Regulatory Tier-1 capital to risk-weighted assets	10.4	10.4	10.3	11.0	11.4
Regulatory Tier-1 capital to total exposure	7.9	8.3	7.9	8.7	9.4
Asset Quality					
Nonperforming loans to total gross loans	2.6	2.9	2.9	3.1	3.3
Nonperforming loans net of specific provisions to capital	-0.7	-0.2	-0.3	-0.4	-0.5
Provisions to nonperforming loans	175.2	157.7	161.8	157.1	151.0
Sectoral Loan Distribution					
Consumer loans	18.4	18.1	18.3	18.9	19.2
Mortgage loans	15.3	15.5	15.2	15.1	15.4
Large corporations	17.6	17.2	21.4	22.2	22.6
Small corporations	15.5	17.0	15.8	14.8	14.3
Medium size firms	17.6	18.3	16.9	16.4	15.4
Small firms	11.4	10.1	9.0	9.1	9.4
Microenterprises	4.3	3.8	3.4	3.6	3.7
Earnings and Profitability					
Return on assets	2.0	1.9	2.1	2.0	2.1
Return on equity	20.0	18.2	21.1	19.2	17.7
Foreign Currency Position and Dollarization					
Share of foreign currency deposits in total deposits	43.6	43.4	49.5	44.1	39.3
Share of foreign currency loans in total credit	41.1	38.4	30.1	28.8	29.4
Liquidity and Funding					
Liquid assets to short-term liabilities (domestic)	31.4	25.3	26.2	26.7	33.0
Liquid assets to short-term liabilities (foreign)	56.4	55.2	47.5	44.9	45.7

Sources: IMF Financial Soundness Indicators and IMF staff estimates.

Figure 1. Peru: Financial Soundness Indicators Amongst Peers



Source: IMF, Financial Soundness Indicators database.

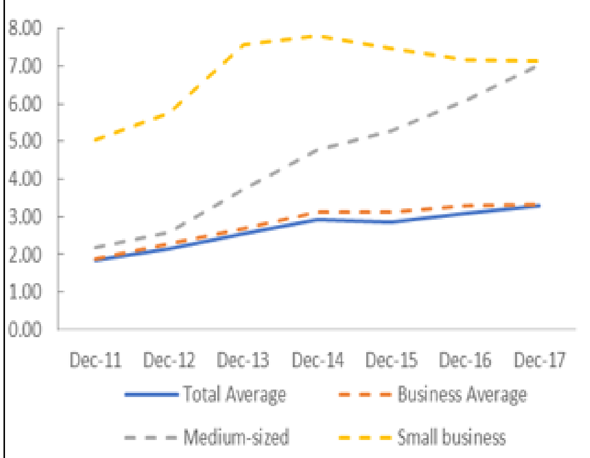
5. NPLs have been rising slowly (3.3 percent at end- 2017), mainly in the medium-sized enterprises segments of the marketplace, which are more affected by the economic cycle. They nevertheless account for only a small share of the system (Figure 2). The recent increase in NPLs is largely due to the pick-up in delinquencies among dollar loans to small-to-medium enterprises and individuals (mainly car loans) that have less capacity to protect themselves against exchange-rate risk.[1] NPLs have remained at a low and stable level in the segments of corporates loans and mortgages.

[1] The higher dollar credit delinquencies reflect in some part the statistical effect of the substitution of credits in dollars for credits in soles, leading to the corresponding decrease in the denominator of NPLs ratios in dollars.

Figure 2. Peru: Credit Delinquency

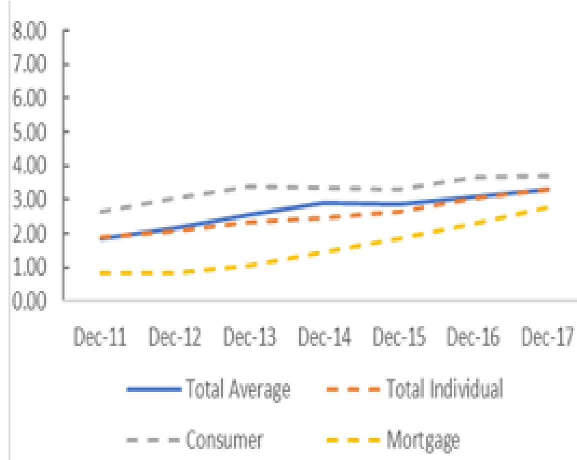
Credit Delinquency Index

(In percent, Dec. 2011 - Dec. 2017)



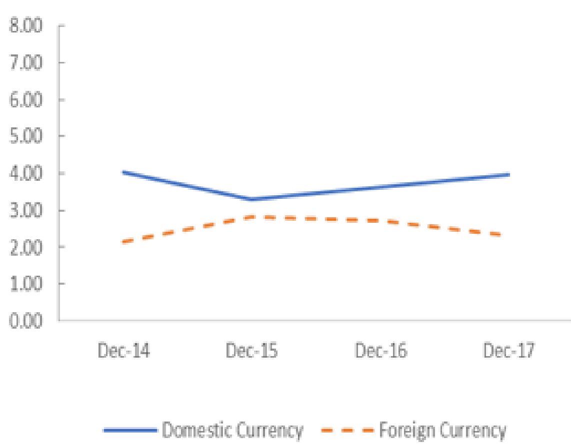
Credit Delinquency Index

(In percent, Dec. 2011 - Dec. 2017)



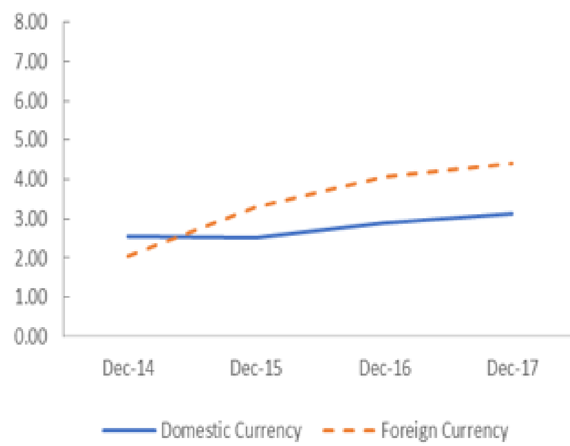
Credit Delinquency Index – Business Average

(In percent, Dec. 2014 - Dec. 2017)



Credit Delinquency Index – Individual Average

(In percent, Dec. 2014 - Dec. 2017)



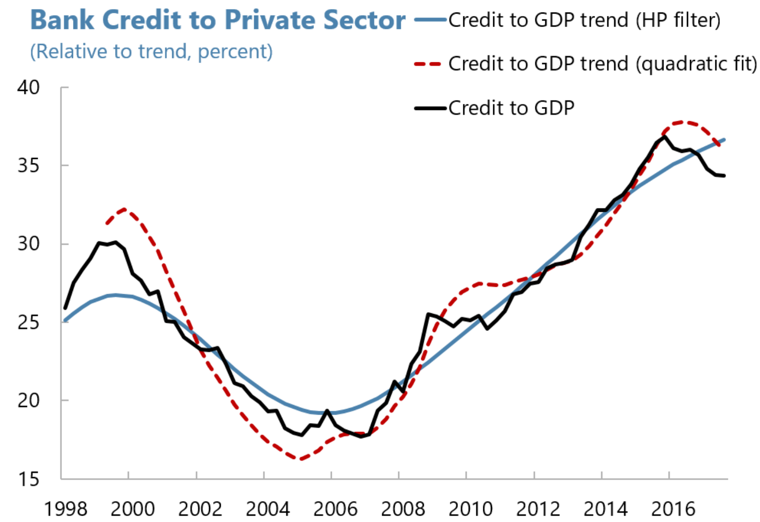
Source: BCRP.

VULNERABILITIES

6. **Peru has been one of the top-performing Latin American economies over the past decade, and prospects remain sound.** Despite a challenging external environment, Peru's average GDP growth exceeded 5 percent during the period 2008 to 2016, while inflation remained subdued, averaging 3.25 percent per year. Real GDP growth slowed down in 2017, largely due to the impact of the El Niño flooding and uncertainty caused by the *Lava Jato* investigation, and is estimated to have closed the year at 2.5 percent (Appendix I). In the coming years, Peru is expected to grow near potential (4.0 percent), driven by increasing investment.

7. **The credit cycle shows a negative gap, but may be at a turning point.** Estimates of the credit cycle, which featured an expansionary phase until the end of 2015, show a negative gap since late 2016. Private credit growth, which has been robust against a backdrop of firm economic activity and continued financial deepening, moderated in 2016 and the first half of 2017, slowing to around 5 percent year-over-year in both years from 14 percent in 2015. Credit growth has, however, accelerated since the second half of 2017 supported by monetary policy actions, and improved terms of trade. Tighter global monetary conditions could moderate the pace of the credit recovery, but are unlikely to fully offset the impact of the credit drivers mentioned above.

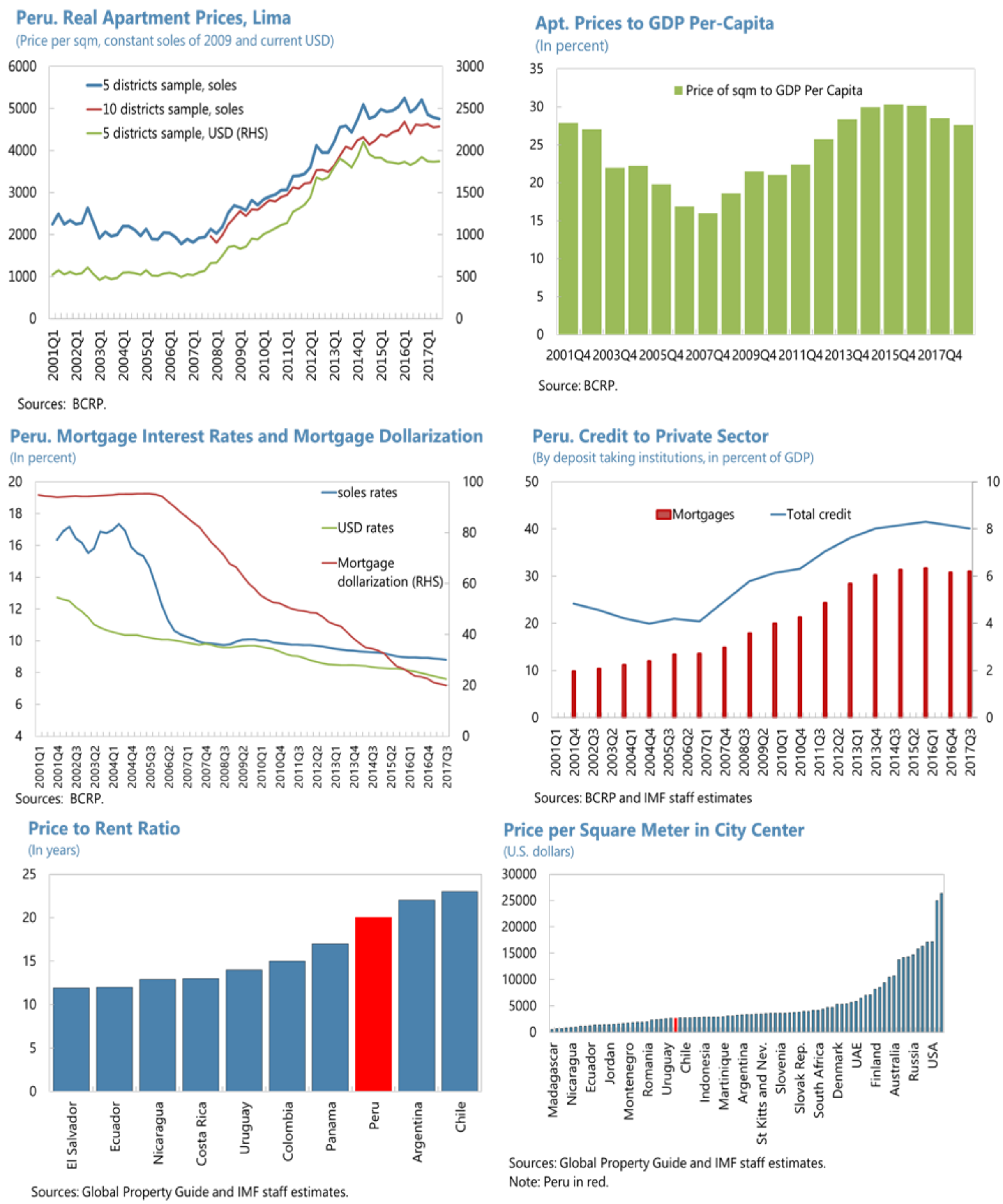
Bank Credit to Private Sector
(Relative to trend, percent)



Source: Haver, IMF staff calculations.

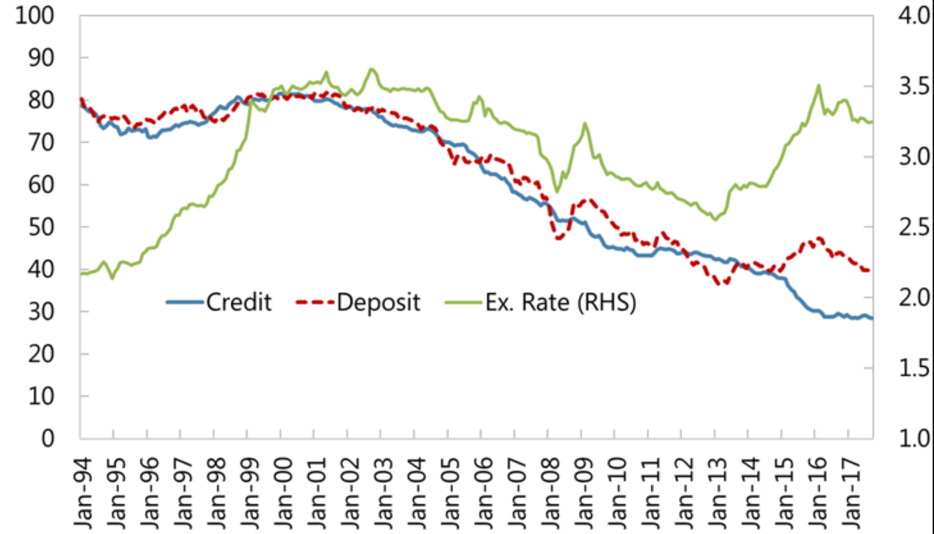
8. **Housing prices have remained stable (Figure 3).** This resilience is probably the result of the strong improvement in the fundamentals of the housing market over nearly two decades. Furthermore, improved economic conditions led to a significant decline in mortgage interest rates, a substantial de-dollarization of mortgage lending, and an increase in mortgage credit. Although indicators of the price-to-rent ratio show that Peru stands relatively high among Latin American countries, the absolute value of this indicator does not appear excessive, especially when compared to a broader sample of countries. In addition, property price indexes in Peru only reflect the capital, Lima, which has a higher population growth rate and a higher urbanization level than the rest of the country.

Figure 3. Peru: Housing Market Indicators



9. Although financial dollarization has declined since the early 2000s, it remains high. After the experience of high dollarization during the1990s, a sustained period of macroeconomic stability and reduced exchange rate volatility led to a gradual decline of dollarization in the financial system. The strong exchange rate depreciation between May 2013 and February 2016 led to a partial reversal of the de-dollarization trend in deposits. Credit de-dollarization, however, has continued, supported by policies and actions implemented by BCRP and the SBS during this period, including disincentivizing lending in foreign currencies, such as through using de-dollarization repos, setting FX credit-reduction targets, and instituting additional capital surcharges on dollar lending. At the end of 2017, under one-third of the credit in the banking system consisted of FX credit, while the FX share of deposits was approximately 40 percent.

Peru: Credit and Deposit Dollarization and the Exchange Rate
(In percent (LHS), Soles per USD (RHS))

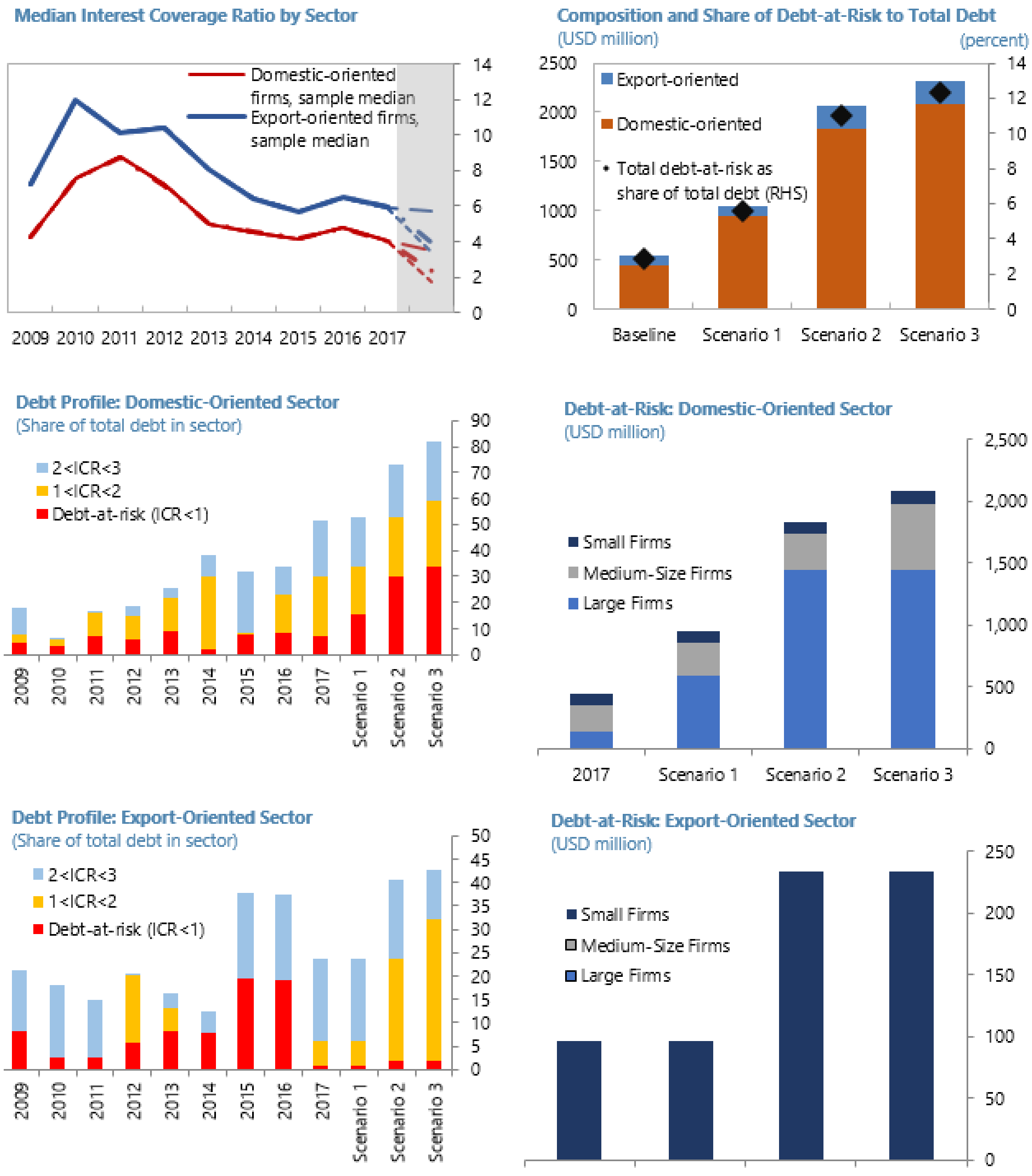


Sources: BCRP and IMF staff calculations.

10. The corporate sector is resilient in general, but domestic-oriented sectors' debt repayment capacity is relatively more sensitive to shocks than other sectors (Figure 4). Staff sensitivity analysis suggests that, based on an analysis of 93 listed firms, the median interest coverage ratio remains above one when a range of FX, earnings, and interest expense shocks are applied.[2] However, this result masks sectoral vulnerabilities. The share of distressed debt in the domestic-oriented sector doubles after the shock. Guarantees to the construction sector pose an indirect risk to banks, an area where the SBS needs to monitor information closely.

[2] Shocks are calibrated to be consistent with the banking sector stress test assumptions. Scenario 1 assumes an FX shock only (a depreciation of the local currency by 15 percent). Scenario 2 adds on an earnings shock of 15 percent and an interest expense increase of 30 percent. Scenario 3 doubles the FX and earnings shocks (to 30 percent respectively) and maintains an interest expense shock of 30 percent. A natural hedge of 75 percent is applied to export-oriented sectors. Debt includes borrowing from banks and issuance of bonds. The share of FX debt is assumed to be 60 percent, considering the higher dollarization of credit to large companies and the greater outstanding stock of bonds issued abroad.

Figure 4. Peru: Corporate Sector Sensitivity Analysis



Source: S&P Capital IQ, Staff calculations.

11. The following vulnerabilities and the risks associated with Peru's financial system formed the basis of the financial stability analysis of the FSAP (Appendix IV).

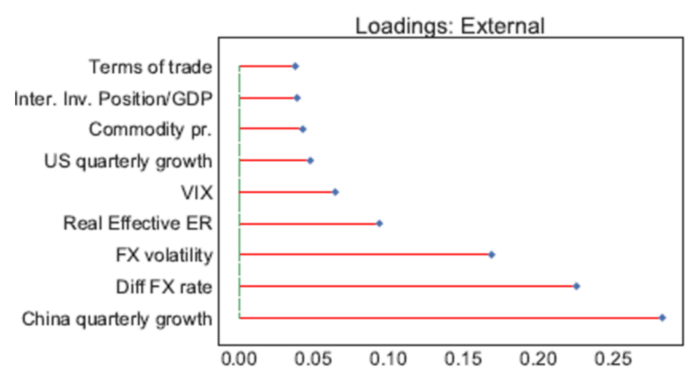
- **Peru remains vulnerable to commodity price volatility.** Mineral exports—largely copper, also gold, lead, and zinc—correspond to a sizeable portion of the economy, representing about 60 percent of total goods exports and slightly over 11 percent of GDP. Thus, structurally weak growth or a significant slowdown affecting major trading partners can worsen the current account deficit (as in 2014, following a marked drop in metal prices) and weaken growth.

- **High financial dollarization continues to be a source of structural vulnerability**. The current levels of credit and deposit dollarization in the financial system are still a source of risk for private sector balance sheets and can exacerbate the contractionary impact of external and domestic shocks. A sharp depreciation can increase defaults among businesses and households that have FX debt, which could lead to higher credit losses for banks.

- **Peru is also vulnerable to domestic headwinds.** Uncertainty due to the ongoing *Lava Jato* corruption investigation is another source of vulnerability. The potential for an extended period of economic and political uncertainty affects the risk appetite of the banking sector, which can reduce investments and infrastructure rebuilding efforts. These factors are accompanied by Peru's general vulnerability to extreme weather events such as the El Niño phenomenon, which can cause damage to infrastructure and reduce mining and agricultural production.

12. The growth-at-risk (GaR) exercise identified external conditions, leverage, and price of risk in Peru as major risk factors that can lead to tail outcomes in terms of GDP growth, consistent with the vulnerabilities identified above. The GaR framework incorporated almost 30 Peru-specific macroeconomic and financial variables to model the conditional distribution of future GDP growth distribution at different horizons, ranging from one quarter to three years. The three risk factors mentioned above were found to have a statistically significant impact on future GDP growth. External conditions (chart), which are mostly driven by the major trading partner's economic growth and by foreign exchange developments in Peru, were identified as the most crucial factors that can lead to tail outcomes for GDP growth. The contribution of these two factors to tail risks is twice as high as the contribution of the other factors (leverage and price of risk) identified.

Variables and Weights Comprising Peruvian External Conditions



Source: IMF staff calculations based on data provided from BCRP and Haver.

SYSTEMIC RISK ASSESSMENT

A. Banking Sector Stress Tests

13. Against this background, the FSAP mission identified the key macrofinancial risks listed below (Appendix III, Risk Assessment Matrix [RAM]). These risks formed the basis of the shocks simulated in the macrofinancial stress scenario, where the shocks are amplified by the vulnerabilities that were identified above.

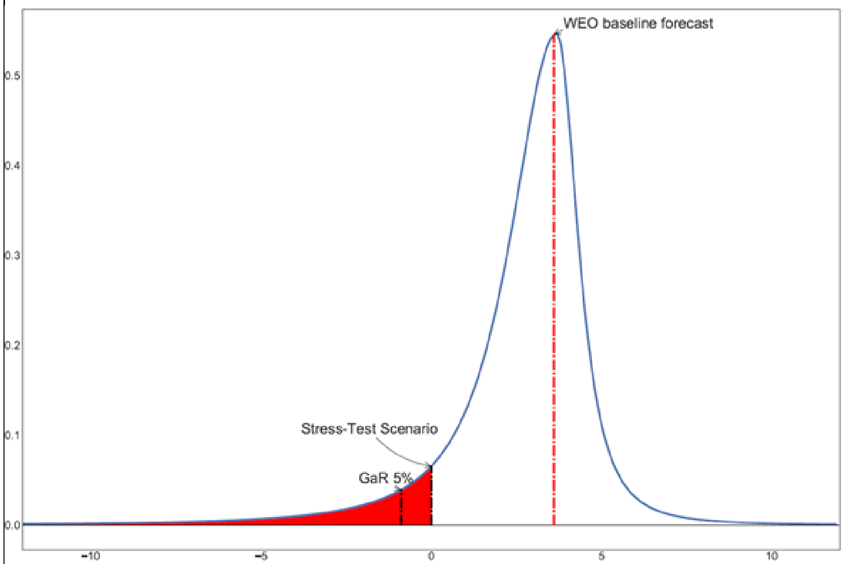
a) A significant slowdown in major export markets and an accompanying decline in the price of minerals, most importantly copper, could adversely affect growth in Peru. Low exports would lead to low growth, low investment, high structural unemployment, and low foreign direct investment, with fiscal pressures for the government. Higher funding needs of the government would lead to higher domestic yields. This would be accompanied by lower profits and less investment for the corporate sector, and lower income for the households. Banks would experience higher NPLs and credit losses due to their direct exposure to the mining sector, but also in their broader credit portfolio due to the overall decline in economic activity with lower investment, lower household income, and higher unemployment.

b) Tightening of global financial conditions and higher volatility will be accompanied by Sol depreciation. Tighter financial conditions would lead to capital outflows from Peru, funding pressures for banks, and higher borrowing costs for nonfinancial corporates borrowing from abroad. This would lead to a reduction in credit demand, investments, and employment. The depreciation of the Sol would exacerbate these conditions. Defaults would increase among businesses and households that have unhedged FX debt, which would lead to higher credit losses for banks. In addition to higher defaults, higher debt service costs for FX loans will reduce consumption and investment demand, further reducing growth.

c) Homegrown economic weakness related to uncertainty and spillovers from the ongoing *Lava Jato* investigation and a repeat of the El Niño event. This could undermine confidence in the economy, and reduce the risk appetite of the banking sector and investment by the nonfinancial businesses. Additionally, it could delay investment and infrastructure rebuilding, and lead to lower growth and, eventually, to higher NPLs. Variables and Weights Comprising Peruvian External Conditions

14. The stress tests conducted in collaboration with the SBS used two scenarios, baseline and adverse, over a three-year horizon. The banking sector stress tests included a top-down exercise based on an adverse macroeconomic scenario and sensitivity analyses. The adverse scenario envisions annual GDP growth shocks of -3.6 percent, -5.1 percent, and -0.9 percent, during the three-year scenario period (Figure 5). The cumulative likelihood of the Peruvian GDP growth path characterizing the adverse scenario was estimated via the GaR model. The likelihood of the adverse GDP growth of -1.2 percent (deviation of 5.1 percent from the baseline) in the second year is estimated to be 4.2 percent, indicating that the scenario is harsh but plausible. While the solvency stress test mostly analyzed on-balance-sheet exposures of banks, the FSAP team incorporated in the test assumptions on the off-balance-sheet guarantees to capture the risk of potential losses from these exposures.

Peru Conditional GDP Distribution

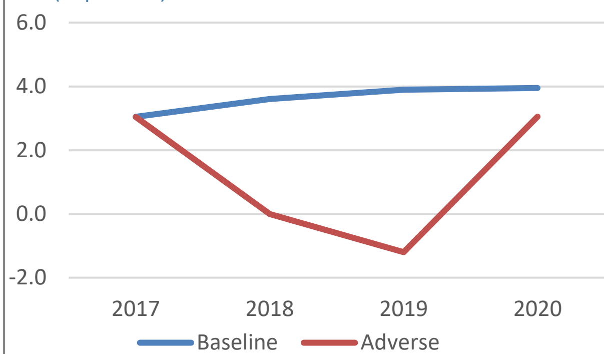


Source: IMF staff.

Figure 5. Peru: Stress Test Scenarios – Baseline and Adverse

Growth in Peru picks up in the Baseline, while slows down significantly for two consecutive years in the Adverse Scenario

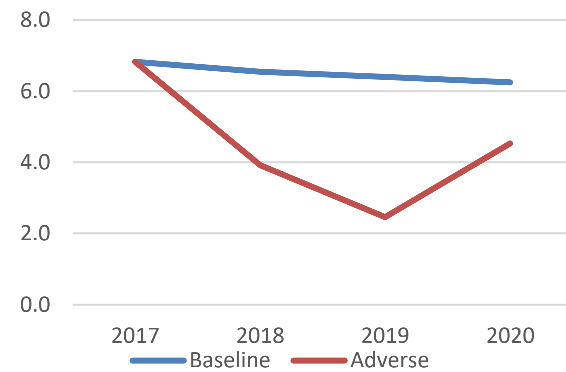
Real GDP Growth - Peru
(In percent)



Source: IMF Staff Estimates.

The major trading partner also experiences a significant slowdown in the Adverse Scenario

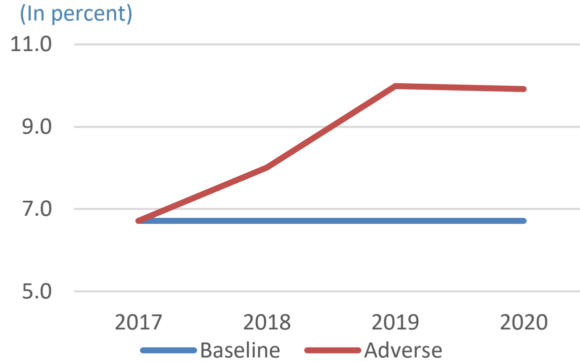
Real GDP Growth - Major Trading Partner
(In percent)



Source: IMF Staff Estimates.

Unemployment increases significantly in the Adverse Scenario and remains elevated

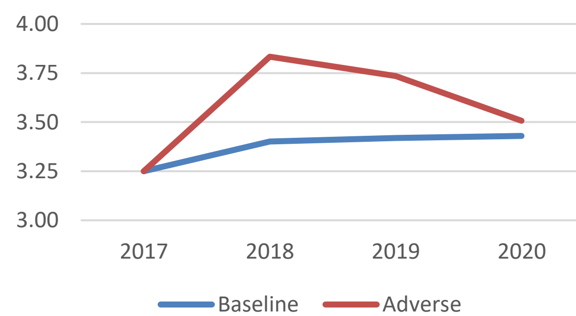
Unemployment
(In percent)



Source: IMF Staff Estimates.

The Sol depreciates sharply in the first year under the Adverse Scenario, and only partially recovers later

Exchange Rate
(Level)



Source: IMF Staff Estimates.

15. The banking system overall appears resilient to severe macrofinancial shocks (Table 4 and Figure 6). The mission's stress test showed that the banking system remains profitable on average, with small declines in system-wide capital levels. The resilience of banks' solvency positions largely stems from their strong initial capital and profitability buffers, which allow them to absorb most of any potential credit and market losses. At the end of the adverse-scenario simulation, all large banks stay above the minimum regulatory CAR threshold of 10 percent, while a few small banks, which hold approximately 6 percent of the total private banking-sector assets, fall below the regulatory threshold. The total capital shortfall is insignificant, at less than 0.1 percent of GDP. Nevertheless, banks' credit losses increase and their profits decline substantially in the adverse scenario, which is likely to lead to risk aversion. Losses experienced by any of the large banks have the potential to reduce total credit provision due to the highly concentrated nature of the banking system. Thus, the banking-sector concentration and correlated exposures of large banks are a source of vulnerability that deserves close monitoring.

Table 4. Peru: Solvency Stress Test Results

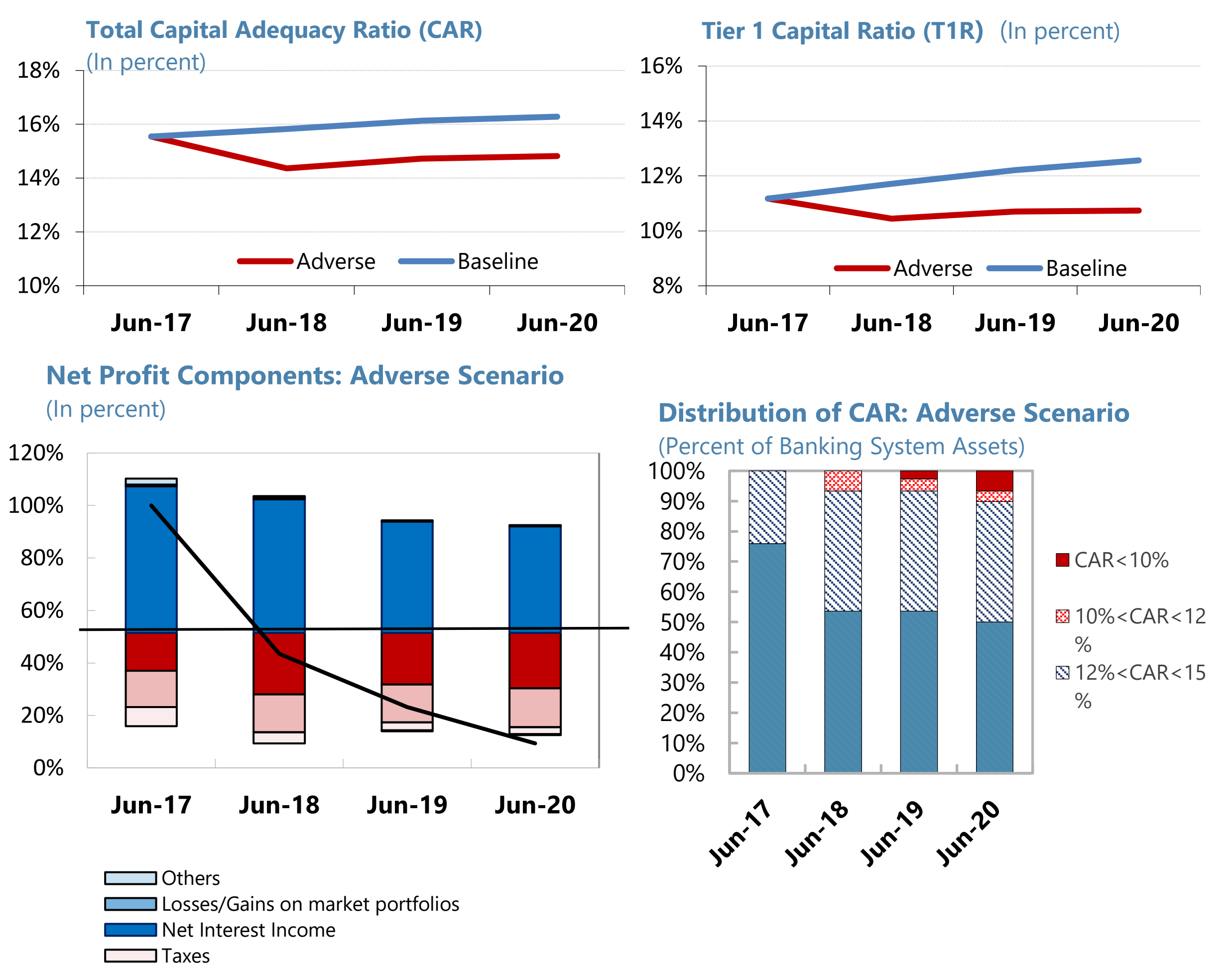
(System Wide Averages)

Total Capital Ratio

Starting Position	Adverse			Baseline		
2017 Q2	2018	2019	2020	2018	2019	2020
percent	percent	percent	percent	percent	percent	percent
15.5	14.4	14.7	14.8	15.8	16.1	16.3

Source: IMF staff estimates

Figure 6. Peru: Stress Test Results – Capital Adequacy

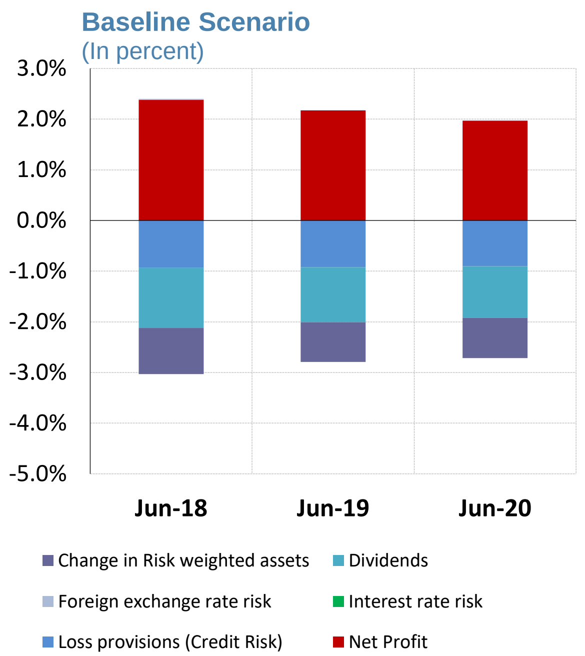


Source: IMF staff estimates.

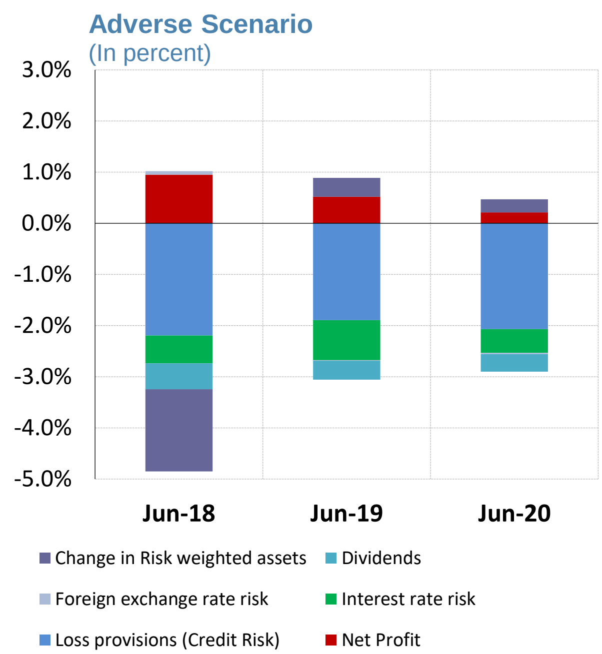
16. The largest driver of the change in capital positions in the adverse scenario is loan-loss provisions (Figure 7). As the economic outlook deteriorates in the simulated adverse scenario, defaults increase significantly. With the loan-loss provisioning ratios also increasing from their baseline levels, the increase in defaults leads to large loan-loss provisions, reducing the capital of banks. The compression in net interest income contributes to the losses to a small extent during the scenario.

Figure 7. Peru: Stress-Test Results – Drivers of the Change in Capital Levels

Positive net profit leads to an increase in capital in the Baseline, while loss provisions and increase in RWA reduces them.



Profits decline in the Adverse Scenario, and loss provisions are the largest driver of the reduction in capital.



Source: IMF staff estimates.

17. The FSAP stress test also incorporated assumptions on off-balance-sheet guarantees to capture the risk of potential losses, particularly those due to the construction-sector-related guarantees. The realization of losses from the construction-sector-related guarantees has been near zero in the past, but, given the current environment, there might be higher losses than previously. The notional value of guarantees corresponds to 118 percent of the total capital of banks, on average. The FSAP team used 60 percent of guarantees as the basis for the loss estimation. The assumed triggering of construction-sector-related guarantees contributed to a decline of approximately 0.3 percentage points in the system-wide total capital ratio.

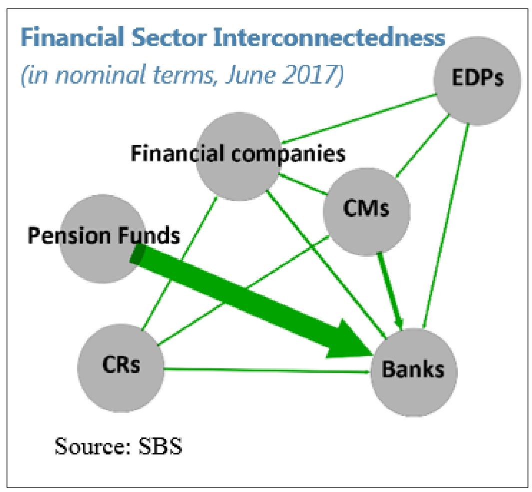
Liquidity Stress Tests

18. The FSAP assessed risks due to the potential volatility that banks' funding sources might display via a cash-flow-based liquidity stress test, as well as regulatory ratios— the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The analysis indicates a limited impact of severe run-off rates of liabilities and haircuts on cash inflows on the overall liquidity position of banks. All banks in the stress test meet the regulatory minimum LCR requirement of 80 percent as of 2017, and in fact they are close to, or above, 100 percent. Similarly, most banks have NSFR well above 100 percent, with only two banks slightly below that level. This metric is currently not binding, and the SBS is working on finalizing the guidance and regulatory requirements related to NSFR.

19. The cash-flow-based liquidity stress test indicated that banks are largely resilient to structural shocks in the simulated scenario. This test used data on the temporal structure of cash flows generated by different liabilities and assets of banks and considered banks' ability to generate cash from liquid as well as less-liquid assets. All banks maintain positive cash buffers up to one-year horizon, which includes central bank reserves. The results, however, were sensitive to the assumption on the run-off rates applied to the unused credit lines. An increase of the assumed run-off rate from 5 percent to 10 percent would lead three banks to experience cash shortfalls. The analysis also indicated that banks' FX liquidity risk was rather limited, with the high level of FX reserve requirements providing a significant buffer against FX liquidity shocks.

Financial Interconnectedness and Contagion Analysis

20. There is limited scope for direct contagion across sub-sectors within Peru. The largest positions across sub-sectors are the deposits of pension funds in the banks and the loans of banks to financial companies and microcredit institutions (EDPs). However, these exposures are small in Peru: The banking sector's reliance on deposits from the non-bank financial sector is limited (pension fund deposits represent less than 3 percent of bank funding), and banking-sector loans to non-bank financial entities remain below 2 percent of banks' capital.[3]



21. The domestic contagion analysis for banks did not find large risks of either direct exposure between the important banks or indirect risks coming from "fire sale" effects. The institutions that hold significant amounts of assets potentially subject to a price decline are also the best-capitalized institutions. A few small banks have large exposures (exceeding 40 percent of their

[3] In addition, insurance companies have some exposure to banks (around 10 percent of their investments), and the pension funds have some small exposures to insurance companies.

capital) to other banks. Regulating the unsecured total exposure of each bank to the banking system would limit the risk that, were a large bank to default, a second wave of defaults by small banks would hurt the reputation (and thus the liquidity) of other banks.

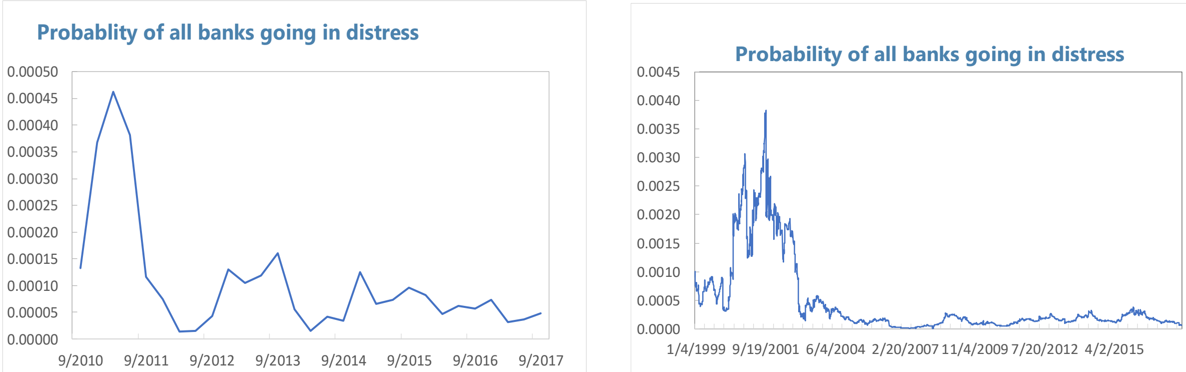
22. The cross-border contagion analysis indicated that potential spillovers would be limited. Despite a large foreign presence in the banking system, direct cross-border banking exposures appear limited, in part because of the establishment of standalone foreign subsidiaries in Peru and limited cross-border activities of domestic Peruvian banks.

23. Although the risk of joint distress has fallen since 2010, banks' common exposures have the potential to amplify shocks since the banking system is concentrated. The risk analysis showed that although the joint probability of distress (PoD) is low, if one bank is already in distress, it is likely that another bank would also experience distress (Figure 8). The PoD have come down since 2010, helped by adequate provisions and higher levels of regulatory capital. The large banks have similar loan portfolios, and credit risk is strongly correlated across banks. As a result of these common exposures, systemic risk indicators show that the conditional likelihood of cascades of distress (the likelihood that at least one additional bank is in distress when a first bank is already in distress) is high and could lead to a systemic event.

Figure 8. Peru: Systemic Risk Metrics

Joint Probability of Distress (Using balance sheet data)

Joint Probability of Distress (Using Moody's KMV EDF)



Source: SBS and staff calculations.

Source: SBS and staff calculations.

24. The authorities should continue strengthening their capacity to monitor systemic risk and to strengthen resilience. The capital surcharges for systemic banks could be increased to levels in line with the Basel III framework in order to build further resilience given the concentration in the banking system. Countercyclical provisions could also be strengthened, which would help smaller banks, which are more exposed to the macroeconomic cycle, and build buffers against potential shocks. Increasing prudential requirements on unsecured interbank exposures would also help contain direct contagion risk. The SBS should also enhance its monitoring of banks' off-balance-sheet exposures, especially exposures to the construction sector. Given the high levels of dollarization and its potential risks, increasing the risk weights for foreign currency loans consistent with Basel III requirements would be an important refinement. The macroprudential toolkit needs to be continuously reviewed to ensure the SBS and the BCRP have the instruments to address potential systemic risks.

Cyber Risk

25. Cyber risk is recognized by the authorities as an important financial stability risk. Cyber risk assessments are part of the operational risk-related regulations. All banks manage cyber risk under their operational risk frameworks, and include incorporating cyber risk in their business impact analysis and stress-testing exercises. They monitor cyber risk regularly, maintain organized cyber risk event databases, and have specific cyber risk insurance coverage. Some would like to see cyber risk standards more specifically included in regulations, aligned with international standards. The SBS has not carried out any cyber-attack simulations so far.

MACROPRUDENTIAL FRAMEWORK AND POLICIES

26. Peru's macroprudential framework, albeit less formal than that of many other countries, has several elements that support effective macroprudential policy in line with IMF guidance. A culture and tradition of close coordination between the BCRP and the SBS has made the existing informal arrangement work well for the last several years. Although there is no designated macroprudential authority, policy coordination is achieved via several channels: high-level staff of the Ministerio de Economía y Finanzas (MEF), BCRP, and the SBS meet on a regular informal basis, and the SBS Superintendent attends the quarterly meetings of the BCRP Board of Directors. The BCRP and SBS have organizational structures to operationalize macroprudential policy. Both institutions conduct systemic risk monitoring and prepare separate Financial Stability Reports, although only the BCRP publishes (semiannually).

27. An enhanced mandate to BCRP and the SBS for macroprudential policy would be desirable to foster the willingness and ability to act. In the absence of such a mandate, there could be a tendency toward policy inaction. A mandate would also help improve accountability and safeguard the strong institutional norms currently in place. In establishing the mandate, it will be important to preserve the institutional independence of the separate policy functions of the BCRP and SBS.

28. The authorities have developed an extensive macroprudential toolkit that has served them well. The bulk of these instruments reside with the SBS, and tools include capital surcharges for systemically important financial institutions, capital conservation buffers, countercyclical capital requirements, dynamic provisioning, liquidity requirements, and capital surcharges for a range of risks. In recent years, the BCRP has implemented strong measures (reserve requirements, FX credit limits, and de-dollarization repos) to reduce dollarization, particularly in household borrowing. Nevertheless, the toolkit needs to be continuously reviewed to ensure that the instruments are appropriate to address potential systemic risks. Increasing risk weights for foreign-currency loans in line with Basel III guidelines would be an important refinement.

29. Implementing a MoU between the BCRP and SBS would further strengthen the coordination framework. The BCRP and SBS could more systematically collaborate on stress testing, including on the design of scenarios and the discussion of results and implications. Efforts should be made to close information gaps, particularly regarding corporate sector, financial cooperatives, housing market, and household-income data. New risk-monitoring tools that this FSAP has developed, could also be introduced, such as GaR, systemic risk models, and monitoring of corporate sector vulnerabilities. This would eventually pave the way for establishing a formal coordination mechanism.

FINANCIAL SECTOR OVERSIGHT

A. Banking Sector Oversight

30. The SBS followed up on most of the recommendations made in 2011Basel Core Principles (BCP) assessment (Annex 1).[4] It expanded its resources and specialized units (for example, information-technology supervision), strengthened consolidated supervision, established continuous monitoring of beneficial ownership, and implemented Pillar 2. In addition, the supervision of more qualitative elements such as governance, management and internal controls, has been improved. One of the few recommendations that has remained unrealized related to the improvement of the legal protection of the SBS staff, for which the General Financial System Law (LGFS) would need to be amended.

31. The SBS has made considerable progress on the implementation of the Basel regulatory reform agenda. While the implemented methodology for the capital conservation buffer, counter-cyclical buffer, and the buffer and framework for D-SIBs is different than that of the Basel framework, the developed approach, tailored to the local characteristics of Peru's financial system, aims to achieve the same objectives. However, the activation trigger of the counter-cyclical buffer could be enhanced, as well as the systemic and single name risk buffers as these are currently not commensurate with the risk they are supposed to cover. A remaining substantive difference is the use of the Basel II capital definition, which is embedded in the LGFS. The SBS also implemented the LCR, is in process of the implementation (tailored to the local characteristics) of the NSFR, and incorporated in its regulatory framework the Basel guidelines for corporate governance.

32. Notwithstanding the progress that has been made, some areas for improvement remain. These include the SBS's internal governance, control and accountability framework, which could be strengthened by enhancing the position of the internal audit department and setting up an

[4] Considering the revisions to the Basel Core Principles (issued in 2012) and the changes to the Basel capital standards since 2011, it was decided to undertake a full graded BCP assessment this time.

Audit Committee, its engagement with the Board of Directors of supervised institutions, and establishing recovery and resolution plans for D-SIBs as well as financial groups.

33. Consolidated supervision is a priority for the SBS, albeit impaired by gaps in the legal framework. Given the legal limitations, the SBS has done a remarkable job over recent years of gathering information on Peruvian financial and mixed conglomerates (in terms of shareholders, management and main activities), and requiring (through enforcement over the supervised entities and through moral suasion) prudential requirements and controls on a group level. However, the lack of formal legal powers to bring the holding company and the wider group within the supervisory perimeter is an issue that needs to be addressed. In addition to obtaining the necessary legal powers, the supervisory approach to the group-level assessment (including the establishment of a group rating and lead supervisor) of governance, risk management, capital adequacy and liquidity risk management needs enhancement.

Bank Regulatory Reform Impact

34. The empirical analysis showed that, in the case of Peru, there were no long-lasting effects of increased capital requirements on credit growth.[5] Over the past decade, Peru has significantly raised bank capital requirements, including the imposition of bank-specific capital buffers. The analysis showed that while loan growth was slightly lower in the first three months following a change in requirements, over any period longer than a quarter, loan growth did not significantly differ between periods with and without a change. These results suggest that gradual implementation coupled with high profitability allowed most Peruvian banks to comply with the higher capital requirements through retained earnings. This may have limited both the need and the incentive to reduce lending.

B. Insurance Supervision

35. Insurance supervision has been strengthened over the recent past, but further work needs to be done. Requirements for insurers' risk management and internal controls have been considerably improved and are expected to be fully implemented during 2018. The SBS has begun the transition from a rules-based supervisory approach to a modern risk-based regime for capital requirements and supervision, but additional changes, including legislative ones, are required. In addition, current regulatory requirements for the valuation of assets and liabilities for solvency purposes need to be updated.

C. Supervision of Cooperatives

36. The FSAP reviewed the effectiveness of the prevailing oversight arrangements and assessed alternative strategies to incorporate the financial cooperatives within the perimeter of supervision by the SBS. The passage of the law that migrates the supervision of the savings and

[5] The study was done by a joint team from MCM and RES (Appendix VI).

credit cooperatives (Cooperativas de Ahorro y Crédito: COOPAC) directly to the SBS, is important to strengthen financial system oversight and control risks. The law will introduce a three-tiered model of supervision: the SBS will supervise eight to ten of the largest COOPACs, Tier 2 institutions will be supervised by Federación de Cooperativas de Ahorro y Crédito (FENACREP) (as per the current model); and Tier 3 COOPACs will be registered and receive basic monitoring. This tiered system will be phased in over several years, during which FENACREP will play a key role.

37. After formalizing the supervision of cooperatives, there will be new responsibilities for deposit protection and the provision of liquidity in times of stress. The current legislation provides for the establishment of a deposit insurance scheme for cooperatives. Considering their unique challenges, such as their inability to directly participate in payment systems, it will be important to evaluate alternative policy options for managing liquidity in times of stress. In addition, adequate fit and proper tests for cooperative management and the ability to swiftly close problem cooperatives will contribute to the sector's stability and soundness.

D. Financial Integrity

38. The authorities continue to deepen their understanding of money laundering/ terrorism financing (ML/TF) risks. The authorities have completed the ML/TF national risk assessment and several sectoral risk assessments. Drug trafficking, corruption, and environmental crimes were identified as key threats, while the informal economy's size and the inadequate controls over movement of cash were listed as major vulnerabilities. The acquisition of real estate was recently noted as a significant ML typology. Following the 2017 national policy (an update of 2011 policy), the authorities are finalizing a national plan for anti-money laundering/ combating the financing of terrorism (AML/CFT).

39. Strengthening risk-based AML/CFT supervision of banks and high-risk reporting entities should continue. The SBS assesses key risk factors for each bank and engages compliance officers to strengthen AML/CFT controls. The current low number of effective sanctions demonstrates the need to strengthen the SBS's sanctioning powers. The financial intelligence unit (FIU) faces operational challenges in supervising more than 6,000 reporting entities (including notaries public). Some financial reporting entities (for example, money exchange businesses and loan companies) should be subject to effective admission licensing or registration frameworks, to facilitate the FIU's AML/CFT supervision.

40. The effective use of other AML/CFT measures should mitigate ML/TF risks from drug trafficking and corruption and address vulnerabilities in the real estate sector. The FIU should continue engaging with reporting entities (especially high-risk ones) to improve the quality of suspicious transaction reports. Robust exchanges of information, including information now covered by bank and tax secrecy restrictions, should bolster financial investigations. Entity transparency (for example, the registry of the beneficial ownership of companies) and implementing customer due-diligence requirements for politically exposed persons should be enhanced to help detect the laundering of illicit proceeds. A law requiring property transactions above a given threshold to be coursed through the formal financial system would have a positive impact in limiting the ML/TF risks from the real estate sector.

FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

41. **The SBS has in place an effective process for the early identification and supervision of problem financial institutions.** The SBS management team is long-tenured, and it possesses significant institutional and financial-industry knowledge. It applies well-seasoned judgment in supervisory actions. In addition, a broad array of internal processes has been established at the SBS' senior-management level for the consideration of supervisory findings, the assignment of ratings, the development of future supervisory strategy, and a determination of whether and which enforcement actions may be necessary.

42. **In addition, Peru's legal foundation for early intervention and resolution is generally well developed, but the SBS's available remedies and actions are subject to broad judicial review, reflecting the constitutional power of the judicial system.** The LGFS provides for a special resolution regime and an SBS administrative process for failing and liquidating banks. However, the Peruvian courts could reverse SBS decisions on the grounds of illegality (for example, lack of compliance with the legal framework, due process of law). In this regard, it would be preferable for the legal framework to limit the remedies awarded under judicial review to monetary damages (rather than the annulment of the SBS decision).

43. **The Peruvian bank resolution framework should be strengthened to deal with systemic cases**. Currently, the SBS uses the LGFS-provided surveillance regime to prepare for intervention. In the surveillance regime, the SBS does not have the authority to take control of a problem institution. In the intervention stage, the SBS is allowed to take control but the operations of the entity cease by operation of law. The authorities should consider whether it would be useful in systemic cases for the SBS to have the authority to appoint a special administrator to take control and prepare to quickly resolve a failing bank. The special administrator would work under the supervision of the SBS. This would only be needed in systemic situations and when other remedies are not likely to be effective.

44. **The mission recommends enhancing the emergency liquidity assistance (ELA) framework** to ensure its effectiveness to respond to the individual and temporary needs of liquidity from certain banks to avoid disturbances to financial stability. This should include clearly defined solvency and collateralization requirements, along with enhanced supervision of recipient entities.

45. **Peru's deposit-insurance program was effective in the most recent failures, but its operational responsibilities may need to be expanded to allow it to carry out its functions in a systemic crisis.** The SBS is the resolution authority, and it makes all decisions (with the concurrence of the BCRP and MEF in exceptional cases) as to the form of the resolution. The Fondo de Seguro de Depósitos (FSD) has no decision-making authority, but it funds the resolution decisions of the SBS. However, the challenges to FSD and SBS will increase in the event of a systemic crisis. As such, it

would be advisable to enhance information-sharing between the SBS and the FSD to be better prepared to address both idiosyncratic and systemic situations. Ensuring confidence in the FSD and avoiding disruption to insured depositors would require a payout of most deposits within seven working days.

46. A high-level CC should be formed to assist in preparing for and managing a financial crisis. The CC could be comprised of the Minister of the MEF, the governor of the BCRP, the Superintendent of the SBS and the President of the FSD. Besides legislative support for a crisis management CC, a MoU should be entered into among the members of this CC and other relevant entities. It should be based on each authority's statutory duties, elaborate on the role of each authority in crisis management, and set out the expectation of cooperation among them toward the shared goal of financial stability.

47. There should be one over-arching national contingency plan framework for financial stability based on each individual agency's contingency plan. The plan can instill confidence that each agency can ensure the orderly management of issues and tasks in its area of responsibility. In addition, an over-arching national plan can ensure that procedures are well coordinated and that there are no gaps or overlaps that could lead to delays or confusion. However, effective implementation in a crisis relies on the ex-ante creation of subcommittees and working groups, the designation of responsibilities, information collection and analysis, documentation, training, and drilling (simulations). Each member of the CC should create a working group to develop CPs, which could be combined to form a national contingency plan.

48. Extraordinary powers may be required to maintain financial stability in a crisis. Although the authorities have some resolution powers that can be used in systemic crisis situations, there should be a more comprehensive framework for such powers that provide for prompt resolution. During an earlier crisis period, a draft law pertaining to extraordinary powers, and the principles to be employed was developed but was not taken up. The authorities should again consider the proposed law, or a similar initiative.

DEVELOPMENTAL CHALLENGES

A. Financial Inclusion

49. Overall, a renewed focus on the implementation of financial inclusion projects is required in order to remain on track to meet the 2021 goals. The National Financial Inclusion Strategy, launched in 2015 and managed by a multisector financial inclusion committee, is working toward six goals (through 65 projects), including increasing the number of people with accounts at a formal financial institution from the current 43 percent level to 75 percent by 2021.[6] Many studies and assessments have been completed, and the focus now is on implementation. In this context, Modelo Peru, a mobile-technology platform developed to increase financial inclusion, has had only

[6] https://globalfindex.worldbank.org/

limited uptake, partly because of lack of interoperability between banks and e-money accounts. It would benefit from a comprehensive review of its technical and business model shortcomings.

B. Pensions

50. It is imperative to implement incentives to retain workers in the private pension system, while also designing reforms to reduce inequities and enhance social protection. The 2016 law allows private pension system contributors that reach the minimum retirement age to withdraw up to 95.5 percent of their capitalized accounts. About 92 percent of contributors that have reached the entitlement age have been withdrawing the maximum allowed. This has led to a short-term expansion of consumption, as also evidenced by a drop in total premiums for annuities of 38 percent over two years as people have not reinvested their capitalized accounts into pension-like products. As a result, long-term social protection goals will be undermined if prompt action is not taken. The 2016 law should be repealed, and further reforms should be designed to improve replacement rates and, increase overall contribution rates. Decreasing the overall cost of the system, for example, by lowering pension management fees through introducing caps on commissions would also be desirable. In the meantime, to design incentives for participants to remain in the current system, policy options include requiring employers to participate at the current contribution rates, making the employer-contributed share ineligible for withdrawal; and, providing incentives to purchase fixed-term annuities.

C. Market Conduct

51. Historically, El Instituto Nacional de Defensa de la Competencia y de la Protección de la Propiedad Intelectual (INDECOPI) has been the main body in charge of consumer protection in all sectors of the economy, and the SBS has been in charge of market conduct regarding financial services. In this context and in accordance with its mandate, in 2017 the SBS updated the regulatory framework to establish market conduct as an essential element of the enterprise culture, its institutional policies and incentives, and to ensure fair treatment for consumers throughout the financial product life cycle. The powers to address complaints pertaining to anti-competitive behavior in all areas of financial services remain with INDECOPI. Nevertheless, there have been limited actions taken by INDECOPI with respect to any such behaviors the financial service industry.

52. The authorities should evaluate the legal and institutional framework to improve competition in the financial sector without also compromising financial stability considerations. Currently, the SBS is limited with respect to the type of supervised entities and its scope in business conduct behaviors, which limits the overall spectrum of activities it can undertake. It is important to consider alternatives to enhance the legal and institutional framework to more effectively oversee all aspects of competition, market conduct, and consumer protection in financial services, while taking into consideration the necessary technical expertise in financial sector matters and minimizing potential conflicts between the different mandates.

D. Capital Markets

53. Concerted efforts should be devoted to confronting structural constraints and to further develop fixed-income markets at all tenors. Developing the repo markets would better facilitate liquidity management of the central bank and market participants and thus foster financial stability. The use of repos should be promoted by improving clearing and settlement infrastructure, and by lowering fees. The public debt management strategy should focus on, among other priorities, greater collaboration between BCRP and the government in short-term issuance, and prioritizing issuance in the medium- and long-term around benchmark tenors to deepen fixed-income markets. It would be also important to review taxation of capital-markets instruments to ensure an even playing field with bank savings products.

Appendix I. Selected Economic Indicators

					Prel.			Proj.			
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Social Indicators											
Life expectancy at birth (years)	74.2	74.4	74.7	...	...	...	...	...	...	...	...
Infant mortality (per thousand live births)	13.5	12.9	12.4	11.9	...	...	...	...	...	...	...
Adult literacy rate	93.8	93.7	94.2	94.2	...	...	...	...	...	...	...
Poverty rate (total) 1/	23.9	22.7	21.8	20.7	21.7	...	...	...	...	...	...
Unemployment rate	5.9	6.0	6.5	6.7	6.8	...	...	...	...	...	...
(Annual percentage change; unless otherwise indicated)											
Production and prices											
Real GDP	5.8	2.4	3.3	4.1	2.5	3.7	4.1	4.2	4.2	4.1	4.0
Real domestic demand	7.3	2.2	2.9	1.1	1.6	4.5	4.7	4.7	4.5	4.5	4.5
Real domestic demand (contribution to GDP)	7.4	2.2	2.9	1.1	1.6	4.4	4.7	4.6	4.5	4.5	4.5
Consumption (contribution to GDP)	4.3	3.1	3.7	2.0	1.7	3.0	2.9	2.9	3.0	3.1	3.1
Investment (contribution to GDP)	3.0	-0.9	-0.7	-1.0	-0.1	1.4	1.8	1.8	1.5	1.3	1.4
Net Exports (contribution to GDP)	-1.5	0.2	0.4	3.0	0.9	-0.7	-0.6	-0.4	-0.3	-0.4	-0.5
Output gap (percent of potential GDP)	1.7	-0.2	-0.9	-0.6	-1.1	-1.1	-0.8	-0.4	-0.2	0.0	0.0
Consumer prices (end of period)	2.9	3.2	4.4	3.2	1.4	2.2	2.0	2.0	2.0	2.0	2.0
Consumer prices (period average)	2.8	3.2	3.5	3.6	2.8	1.3	2.0	2.0	2.0	2.0	2.0
External sector											
Exports	-9.6	-7.8	-12.9	7.6	21.3	13.2	4.0	3.6	3.6	3.9	4.1
Imports	3.3	-3.1	-9.0	-5.9	10.0	9.8	6.0	5.7	5.6	5.1	5.7
Terms of trade (deterioration -)	-5.2	-5.4	-6.4	-0.7	7.3	6.0	0.4	-0.2	-0.5	0.2	0.4
Real effective exchange rate (depreciation -)	-0.2	-1.6	0.8	-2.4	1.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Money and credit 2/ 3/											
Broad money	15.3	9.5	11.6	4.3	8.8	8.8	8.5	7.9	7.6	7.5	7.6
Net credit to the private sector	18.3	13.2	14.0	5.0	5.1	7.5	7.3	6.8	6.6	6.5	6.6
(In percent of GDP; unless otherwise indicated)											
Public sector											
NFPS revenue	28.4	27.7	24.9	23.2	23.0	23.4	23.9	24.3	24.7	24.7	24.6
NFPS primary expenditure	26.4	26.9	25.9	24.6	24.9	25.4	25.2	24.7	24.2	24.2	24.2
NFPS primary balance	2.0	0.8	-1.0	-1.4	-1.9	-2.0	-1.3	-0.4	0.5	0.5	0.5
NFPS overall balance	0.9	-0.3	-2.0	-2.5	-3.1	-3.3	-2.7	-1.9	-1.0	-1.0	-1.0
NFPS structural primary balance 5/	0.8	-0.3	-0.5	-1.1	-1.5	-1.7	-1.1	-0.4	0.5	0.5	0.5
External sector											
External current account balance	-4.7	-4.4	-4.8	-2.7	-1.3	-1.7	-1.8	-1.9	-2.0	-2.0	-2.0
Gross reserves											
In billions of U.S. dollars	65.7	62.4	61.5	61.7	63.7	63.7	64.2	64.2	64.2	64.2	64.2
Percent of short-term external debt 4/	536	534	523	450	312	478	454	506	508	509	515
Percent of foreign currency deposits at banks	274	258	224	230	225	220	222	224	228	232	238
Debt											
Total external debt 6/	30.6	34.1	38.1	38.2	35.7	33.1	31.2	30.2	28.9	27.6	26.4
Gross non-financial public sector debt 7/	20.4	20.6	23.9	24.4	25.3	26.6	27.6	27.7	27.2	26.6	26.2
External	9.0	8.7	11.1	10.3	8.7	8.5	8.3	8.5	8.3	8.1	7.8
Domestic	11.4	11.8	12.8	14.0	16.6	18.2	19.4	19.3	18.9	18.6	18.3
Savings and investment											
Gross domestic investment	26.5	24.9	24.1	22.6	21.4	21.9	22.6	23.3	23.8	24.1	24.5
Public sector (incl. repayment certificates)	5.9	5.6	5.0	4.8	4.5	4.8	5.0	5.1	5.1	5.1	5.1
Private sector (incl. inventories)	20.6	19.3	19.1	17.8	16.9	17.1	17.6	18.2	18.7	19.0	19.4
National savings	21.7	20.5	19.3	19.9	20.2	20.2	20.8	21.4	21.8	22.1	22.5
Public sector	7.2	6.0	3.8	2.7	2.0	2.2	3.0	3.8	4.7	4.8	4.8
Private sector	14.6	14.5	15.6	17.2	18.2	18.0	17.7	17.5	17.1	17.3	17.6
Memorandum items											
Nominal GDP (S/. billions)	534.7	576.5	612.7	659.7	701.8	749.0	796.9	848.1	901.6	958.0	1016.6
GDP per capita (in US$)	6,629	6,586	6,168	6,208	6,762	7,198	7,533	7,823	8,133	8,486	8,864

Sources: National authorities; UNDP Human Development Indicators; and Fund staff estimates/projections.
1/ Defined as the percentage of households with total spending below the cost of a basic consumption basket.
2/ Corresponds to depository corporations.
3/ Foreign currency stocks are valued at end-of-period exchange rates.
4/ Short-term debt is defined on a residual maturity basis and includes amortization of medium and long-term debt.
5/ Adjusted by the economic cycle and commodity prices, and for non-structural commodity revenue. The latter uses as equilibrium commodity prices a moving average estimate that takes 5 years of historical prices and 3 years of forward prices according to IMF
6/ Includes local currency debt held by non-residents and excludes global bonds held by residents.
7/ Includes repayment certificates.

Appendix II. Detailed Financial Soundness Indicators

	2012	2013	2014	2015	2016	2017
	(as of December)					
Capital Adequacy						
Capital to risk-weighted assets 2/	14.4	13.9	14.2	14.3	15.1	15.2
Regulatory Tier I capital to risk-weighted assets 3/	10.9	10.4	10.4	10.3	11.0	11.4
Nonperforming loans net of provisions to capital 4/	-2.0	-0.7	-0.2	-0.3	-0.4	-0.5
Leverage 5/	7.9	7.9	8.3	7.9	8.7	9.4
Asset Quality						
Nonperforming loans to total gross loans 4/	2.2	2.6	2.9	2.9	3.1	3.3
In domestic currency	3.0	3.3	3.4	2.9	3.2	3.6
In foreign currency	1.1	1.5	2.1	2.9	2.8	2.6
Nonperforming, refinanced and restructured loans to total gross loans 4/ 6/	3.2	3.6	4.0	4.0	4.4	4.8
In domestic currency	4.2	3.3	3.4	2.9	3.2	3.6
In foreign currency	1.8	1.5	2.1	2.9	2.8	2.6
Refinanced and restructured loans to total gross loans	1.1	1.0	1.1	1.1	1.3	1.5
Provisions to nonperforming loans 4/	202.0	175.2	157.7	161.8	157.1	151.0
Provisions to nonperforming, restructured, and refinanced loans 4/ 6/	134.9	126.3	114.4	116.5	111.1	104.9
Sectoral distribution of loans to total loans						
Consumer loans	19.1	18.4	18.1	18.3	18.9	19.2
Mortgage loans	14.7	15.3	15.5	15.2	15.1	15.4
Large corporations	15.8	17.6	17.2	21.4	22.2	22.6
Small corporations	15.3	15.5	17.0	15.8	14.8	14.3
Medium size firms	17.5	17.6	18.3	16.9	16.4	15.4
Small firms	12.5	11.4	10.1	9.0	9.1	9.4
Microenterprises	5.2	4.3	3.8	3.4	3.6	3.7
Earnings and Profitability						
Return on equity (ROE)	21.5	20.0	18.2	21.1	19.2	17.7
Return on assets (ROA)	2.2	2.0	1.9	2.1	2.0	2.1
Financial revenues to total revenues	82.7	85.6	85.0	85.1	85.3	84.2
Annualized financial revenues to revenue-generating assets	11.2	10.9	10.6	10.5	10.1	10.2
Liquidity						
Total liquid assets to total short-term liabilities (monthly average basis)	45.0	43.0	39.4	37.7	35.4	38.5
In domestic currency	44.2	31.4	25.3	26.2	26.7	33.0
In foreign currency	46.2	56.4	55.2	47.5	44.9	45.7
Deposit-to-loan	95.2	98.1	90.5	92.0	88.4	92.1
Foreign Currency Position and Dollarization						
Share of foreign currency deposits in total deposits	38.2	43.6	43.4	49.5	44.1	39.3
Share of foreign currency loans in total credit	44.4	41.1	38.4	30.1	28.8	29.4
Operational efficiency						
Financing to related parties to capital 7/	11.5	9.3	9.4	12.3	9.1	9.6
Nonfinancial expenditure to total revenues 8/	33.6	33.7	33.0	30.9	30.8	30.7
Annualized Nonfinancial expenditure to total revenue-generating assets 8/	4.6	4.3	4.1	3.8	3.7	3.7
Memorandum items						
General Stock market index, IGBVL	20,629	15,754	14,794	9,849	15,567	19,974
EMBI+ PERU spread, basis points	117	174	181	243	170	112

Source: National authorities.

1/ These indicators correspond to depository corporations.

2/ Since July 2009, the regulatory capital requirement applied to all risks: credit, market and operational risk.

3/ Since July 2009, Banking Law component establishes that the Tier I capital have to be defined, and Risk-weighted assets include overall risks (credit, market and operational).

4/ Nonperforming loans are overdue loans after 15 days since the due date for commercial loans, and after 30 days for small businesses loans. In the case of mortgage, consumer and leasing loans, they are considered overdue after 30 days since the due date only for the non paid portion and after 90 days for all the credit. The overdue loans include credits under judicial resolution. Figures are net of specific provisions.

5/Tier I regulatory capital / Total Exposure (on-balance sheet exposures, derivative exposures and off-balance exposures converted into credit exposure equivalents using credit conversion factors).

6/ Includes restructured loans, refinanced loans, and arrears. Refinanced loans refer to those loans subjected to either term and/or principal modifications with respect to the initial debt contract. Restructured loans refer to those loans whose payments have been restructured according to the "Ley General del Sistema Concursal."

7/ Financing to related parties corresponds to those loans to individuals and firms owning more than 4 percent of the bank.

8/ Nonfinancial expenditures do not consider provisions nor depreciation.

Appendix III. Risk Assessment Matrix (RAM)[1]

Risk	Overall Level of Concern	
	Relative Likelihood	Expected Impact if Materialized
Structurally weak growth in key advanced and emerging economies / significant China slowdown and its spillovers. Weaker global demand would lead to a decline in commodity prices, worsen the current account deficit and weaken growth, especially through lower exports.	**High / Medium**	**Medium** Low exports will lead to low growth, low investment, high structural unemployment, and low FDI, with fiscal pressures for the government. Higher funding needs of the government will lead to higher domestic yields. This will be accompanied by lower profits for the corporate sector and lower income for the households. Lower corporate profits and household income, together with higher unemployment, will lead to higher NPLs and credit losses for the banks.
Tightening of global financial conditions and higher volatility, accompanied by significant strengthening of the U.S. dollar against the Sol. Balance sheets will be strained for U.S. dollars.	**High**	**High** Tighter financial conditions will lead to funding pressures for banks, and higher borrowing costs for nonfinancial corporates. Defaults will increase among corporates and households that have unhedged FX debt, which will lead to higher credit losses for banks. Higher debt service costs for FX loans will reduce consumption and investment demand, further reducing growth. On the positive side, the depreciation will strengthen the competitiveness of corporates.
Homegrown economic weakness. Extended period of uncertainty plus spillovers from ongoing *Lava Jato* corruption investigation and a repeat of an El Niño shock could reduce investment and infrastructure rebuilding.	**Medium**	**Medium** Lower investment and growth will lead to higher defaults and credit losses for the banks.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Appendix IV. Banking Sector Stress Testing Matrix (STeM)

Domain		Top-down Stress Test by FSAP Team - Assumptions
Banking Sector: Solvency Risk		
1. Institutional Perimeter	Market share of institutions included	A set of banks that hold approximately 92 percent of the banking sector assets
	Data source and baseline date	• Data source: supervisory and publicly-available data • Baseline date: end-June 2017. • Scope of consolidation: consolidated level data for banks that have their headquarters in Peru and subsidiary level data for the subsidiaries of foreign banks.
2. Channels of Risk Propagation	Methodology	Balance sheet-based approach.
	Satellite models for macro-financial linkages	• SBS satellite models for NPL ratio and provisioning ratio for credit losses. • Methodology to calculate market losses from holdings of debt instruments (sovereign and other issuers). • Methodology to calculate sovereign risk. • Net fee income and commission income projected based on nominal GDP growth and expert judgment. • Methodology to calculate shocks to bank funding costs.
	Stress test horizon	3 years (2017 Q3-2020 Q2)
3. Tail Shocks	Scenario analysis	• Scenario-based tests, that assess the impacts on the entire portfolio including the loans and, if applicable, the trading book, will be conducted in the top-down exercise. • Variables in the scenarios include domestic macrofinancial variables (for example, GDP, inflation, exchange rate). • Baseline scenario based on the October 2017 IMF World Economic Outlook (WEO) projections. Equity prices are assumed to move in line with nominal GDP, and house prices are projected based on a regression analysis. • Adverse scenarios are simulated using the IMF's Flexible System of Global Models. • The adverse scenario is driven by a combination of external shocks amplified by domestic characteristics, including existing vulnerabilities and policy constraints, see RAM. The three major drivers of the adverse scenario are: - Shock 1. Structurally weak growth in key advanced and emerging economies, including a significant slowdown in China. - Shock 2. Tightening of global financial conditions and higher volatility that will be accompanied by a depreciation of the Sol. - Shock 3. Homegrown economic weakness related to uncertainties and spillovers from the ongoing *Lava Jato* investigation and a repeat of the El Niño event. • Under the adverse scenario, the Peruvian economy goes through a V-shaped growth path, with a cumulative deviation of real GDP growth of close to 8.8 percentage points over the first two years.

Domain		Top-down Stress Test by FSAP Team - Assumptions
	Sensitivity analysis	• Sensitivity analyses will be conducted to supplement the scenario analysis. • They will evaluate impacts of three different single risk factors on the existing capital buffers as of 2017 Q2: - Exchange rate risk; - Interest rate risk; and - Concentration risk
4. Risks and Buffers	Risks/factors assessed	• Credit loss from banks' loan portfolios and sovereign exposures, including off-balance sheet credit guarantees. • Market loss from valuation adjustments of banks' holding of debt securities and existing net open foreign exchange positions. • Losses from bonds and money market instruments (sovereign and other issuers) in the banking and trading books. • Increase in funding costs.
	Behavioral adjustments	• Passive balance sheet assumption: (1) the balance sheet growth is identical to the overall credit growth, which is linked to nominal GDP growth (with a zero-floor); (2) the balance sheet composition remains constant throughout the stress test horizon; (3) banks build capital only through retained earnings; and (4) maturing capital instruments are not renewed. • Dividends are paid out by banks that remain adequately capitalized throughout the stress period. The dividend payout ratio is assumed to be 50 percent.
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Projected losses distributed across different asset classes. • Point in time probability of default and downturn loss-given default used for calculating credit losses. • Risk weights of the untriggered off-balance sheet guarantees are assumed to increase from 50% to 75%. The 25-percentage point increase corresponds to a roughly 3-notch downgrade of loan exposures.
	Regulatory/ accounting and market-based standards	• Basel II standardized approach.
6. Reporting Format for Results	Output presentation	• System-wide capital shortfall. • Percentage of banking assets in the system that fall below the capital.
Banking Sector: Liquidity Risk		
1. Institutional Perimeter	Market share of institutions included	A set of banks that hold approximately 92 percent of the banking sector assets.
	Data and baseline date	• Source: Supervisory data. • Baseline date: End-June 2017. • Scope of Consolidation: Consolidated level data for banks that have their headquarters in Peru, and subsidiary level data for the subsidiaries of foreign banks.
2. Channels of Risk Propagation	Methodology	• Cash-flow based liquidity stress test using maturity buckets. • Basel III-LCR and NSFR ratios. • All analyses are carried out separately for the Sol and USD.

Domain		Top-down Stress Test by FSAP Team - Assumptions
3. Risks and Buffers	Risks	• Funding liquidity (liquidity outflows). • Market liquidity (price shocks) and haircuts.
	Buffers	• Counterbalancing capacity (HQLA). • Central Bank facilities.
4. Tail shocks	Size of the shock	• Run-off rates calculated following historical events and LCR/NSFR rates. • Bank run and dry up of wholesale funding markets, taking into account haircuts to liquid assets.
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	• National regulatory framework. • LCR: 100 percent, consistent with Basel III LCR framework. • NSFR: Basel Committee on Banking Supervision (2014), "Basel III: The Net Stable funding ratio" Basel, October.
6. Reporting Format for Results	Output presentation	• System-wide liquidity gaps. • Survival period by bank, number of banks that can still meet their obligations.
Banking Sector: Interconnectedness		
1. Institutional Perimeter	Institutions included	• A set of banks that hold approximately 92 percent of the banking sector assets. • Other major non-bank financial institutions.
	Data and baseline date	• Source: Supervisory data. • Baseline date: End-June 2017. • Scope of Consolidation: Consolidated level data for banks that have their headquarters in Peru, and subsidiary level data for the subsidiaries of foreign banks.
2. Channels of Risk Propagation	Methodology	• Interbank model by Cifuentes et al (2005). • Cross-border network model by Espinosa-Vega and Solé (2010).
3. Risks and Buffers	Risks	• Credit and funding losses related to interbank cross-exposures (and cross-border banking exposures). • Fire-sale of assets.
	Buffers	• Banks' own capital and liquidity buffers.
4. Tail shocks	Size of the shock	• Pure contagion: default of institutions. • Fire sale haircuts.
6. Reporting Format for Results	Output presentation	• Network analyses with supervisory data. - System-wide capital shortfall. - Bank-level capital shortfall. - Number of undercapitalized and failed institutions, and their shares of assets in the system. • Evolution and direction of spillovers.

<table>
<tr><th colspan="2">Domain</th><th>Top-down Stress Test by FSAP Team - Assumptions</th></tr>
<tr><th colspan="3">Systemic Risk Analysis</th></tr>
<tr><td rowspan="2">1. Institutional Perimeter</td><td>Market share of institutions included</td><td>A set of banks that hold approximately 92 percent of the banking sector assets.</td></tr>
<tr><td>Data and Starting position</td><td>• Period of analysis: January 2011-August 2017.
• Supervisory data.
• Scope of consolidation: perimeter of individual banks.</td></tr>
<tr><td>2. Channels of Risk Propagation</td><td>Methodology</td><td>• Construction of probabilities of distress of individual institutions based on balance-sheet data.
• Systemic risk analysis (Segoviano and Goodhart (2006); Segoviano and Espinoza (2017).</td></tr>
<tr><td rowspan="2">3. Risks and Buffers</td><td>Risks</td><td>• Method captures systemic risk from common exposures and fire-sale externalities.</td></tr>
<tr><td>Buffers</td><td>• Banks' own capital and liquidity buffers.</td></tr>
<tr><td>4. Tail shocks</td><td>Size of the shock</td><td>• Shocks to balance sheets are those obtained from the banking sector solvency stress test.</td></tr>
<tr><td>6. Reporting Format for Results</td><td>Output presentation</td><td>• Systemic risk indicators:
- Expected number of banks in distress if one is in distress.
- Distress dependence matrix.
• Marginal contribution to systemic risk.</td></tr>
</table>

Appendix V. Implementation of 2011 FSAP Recommendations

Sector	Recommendation	Timing	Status[1]
Banking and Nonbanking Institutions Oversight	• Strengthen consolidated supervision and regulate holding companies • Include credit cooperatives under SBS's supervision and in FSD • Increase the number and caliber of SBS' on-site inspection staff • Tighten regulations on related party and intra-group transactions • Develop benchmarks to evaluate the effectiveness of management	Immediate Immediate Immediate Immediate Medium	Done Underway Done Done Partial[2]
Pension Funds	• Update mortality tables for pension annuities • Eliminate requirement for the SBS to pre-authorize issuers and instruments in which pension funds (AFPs) can invest after introducing a risk-based supervision framework. • Increase pension fund investment foreign asset limit to 50 percent • Develop a risk-based supervision framework for AFPs based on market risk monitoring, an exogenous benchmark, and relative VaR	Immediate Medium Medium Medium	Done Done Done Underway
Payments System	• Guarantee finality and recognition of netting schemes, by minimizing the risk of unwinding • Consider more geographically distant production and back-up processing for systemically important payment systems	Medium Medium	Underway Not Done
Other	• Provide CONASEV with strong independence, including authority over its own budget and administrative matters, and legal protection against suits similar to SBS staff. • Design and enact a special resolution regime for systemic situations • Increase FSD resources by raising fees and (or) reducing coverage • Formalize macroprudential policy coordination committee and enhance information exchange relevant for systemic stability	Immediate Medium Immediate Immediate	Partially Done No Progress Not Done Partial[3]

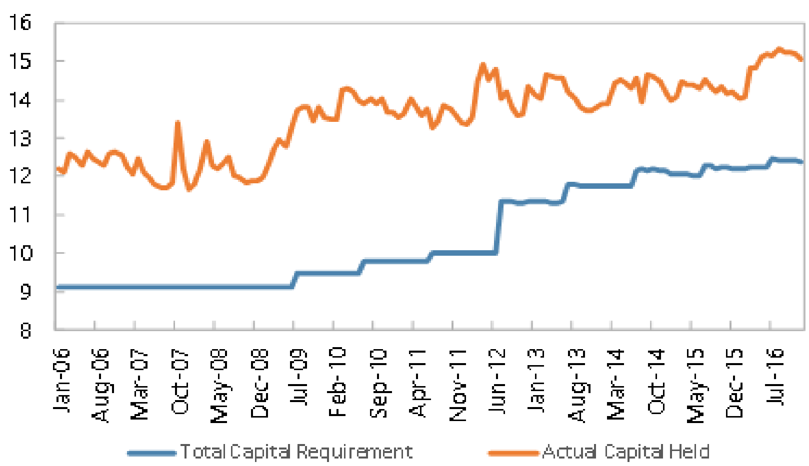
[1] As reported by the authorities.
[2] Risk-based supervision model still being developed.
[3] A macroprudential policy coordination committee has not been established yet.

Appendix VI. The Effect of Higher Bank Capital Requirements on Credit in Peru[1]

1. The study focuses on banks' regulatory capital requirements on credit in Peru. This project was undertaken in the broader context of the FSB's "*Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms*," (FSB, July 2017).

2. In Peru, capital requirements have been raised in two phases. During 2009-2011, uniform minimum requirements were increased from 9.1 percent to 10 percent of risk-weighted assets (RWA). Subsequently, the SBS also introduced bank-specific capital buffers, that come on top of the 10 percent uniform minimum. The buffers were implemented in steps during 2012-2016. (Figure 1.) They consist of a countercyclical component, which can be switched on and off, and a non-cyclical component. At full implementation, buffer requirements typically ranged between 2 percent to 5 percent of RWA. (Figure 2.)

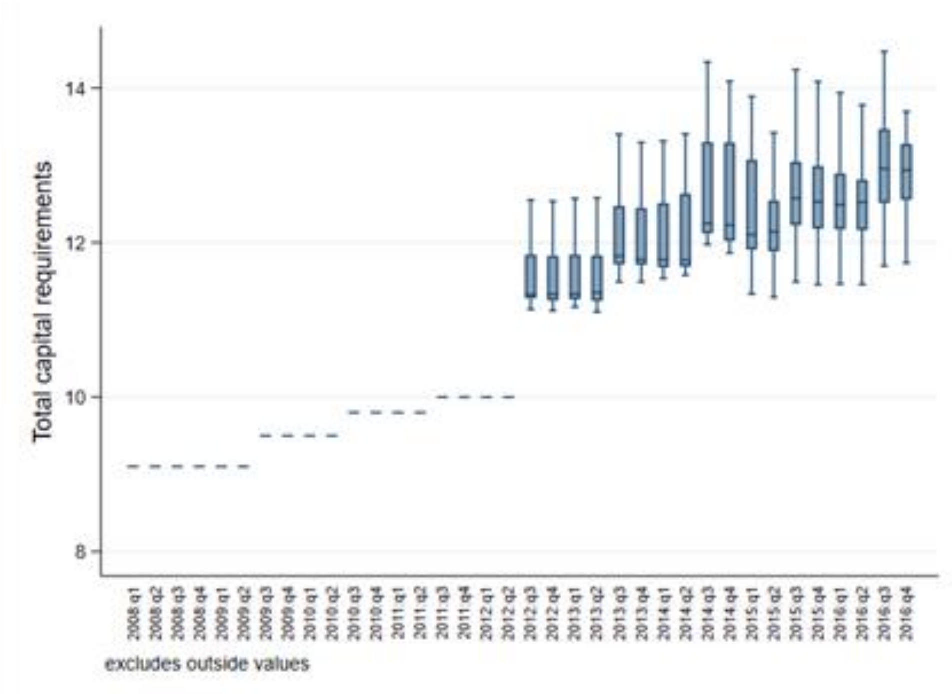
Appendix Figure 1. Actual and Required Capital
(Average, in percent of RWA)



Notes: The chart plots average actual and required capital for the 14 banks in the sample, weighted by assets,

[1] Authors: Xiang Fang (UPenn), David Jutrsa (MCM), Soledad Martinez Peria (RES), Andrea F. Presbitero (RES), Lev Ratnovski (RES), Felix Várdy (MCM).

Appendix Figure 2. Heterogeneity of Capital Requirements



Notes: The chart plots the distribution of capital requirements across the 14 banks in the sample. Each box shows the inter-quantile range and the horizontal line corresponds to the median. The two values above and below the box correspond to the levels of capital requirements closest to the 75th and 25th percentiles, respectively.

3. **The second phase allows for an econometric analysis of the effect of capital requirements on credit that takes advantage of the buffers' heterogeneity across banks.** In the baseline specification, cumulative credit growth has been considered over longer periods "straddled" around jumps in capital requirements. Comparing credit growth across banks and over time reveals by how much, if any, banks faced with higher capital requirements grew their lending vis-à-vis banks with lower requirements. This constitutes a "difference-in-difference" analysis. By looking at increasingly longer straddles, it is possible to see how durable the effect was.

4. **The following regression equation is estimated:**

For *r*, *s* ∈ {0, 1, 2…},

$$\Delta L^i_{t+r,t-s} = \beta_{r,s}\Delta KR^i_{t,t-1} + \delta X^i_{t-s} + \alpha^i + \tau_t + \varepsilon^i_t \quad (1)$$

Here, the dependent variable is loan growth, while the key explanatory variable is the change in the required capital buffer. Formally, $\Delta L^i_{t+r,t-s}$ is defined as the log-difference in the stock of outstanding gross loans of bank i between the end of quarter $t + r$ and the end of quarter $t - s$. The change in the required capital buffer, $\Delta KR^i_{t,t-1}$, is defined as the percentage point difference in bank i's capital requirement in quarters t versus t - 1. Standard errors are clustered at the bank level to allow for autocorrelation within banks.

5. The regression equation in (1) includes both bank and time fixed effects. Unobserved bank heterogeneity is absorbed by bank fixed effects, α^i, while all macroeconomic and policy shocks affecting banks equally (for example, changes in economic growth and monetary policy) are absorbed by time fixed effects, τ_t. This means that the coefficients of interest, $\beta_{r,s}$, are solely estimated off the degree to which an above-average increase in capital requirements leads to an above-average drop in credit growth.

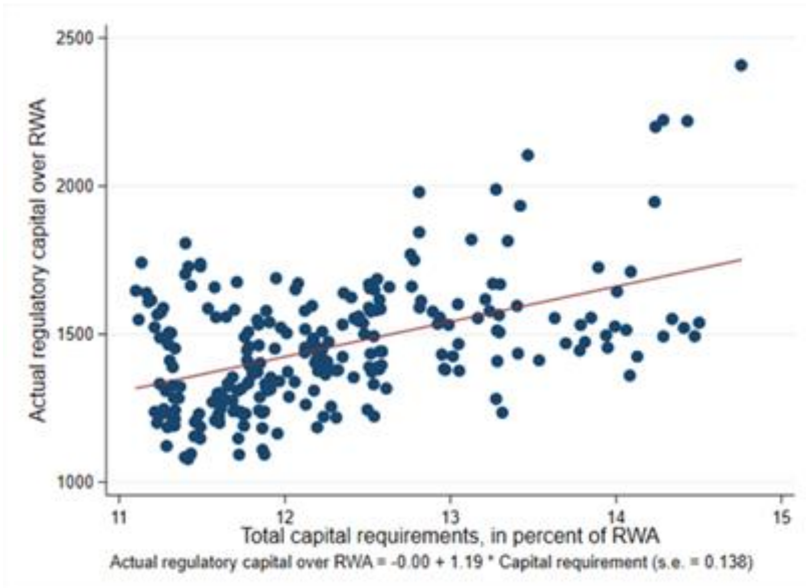
6. To facilitate replicability of the analysis in other contexts, the set of time-varying, bank-specific controls, X^i_{t-s} , is parsimonious. It includes: (1) bank size, measured by the logarithm of total assets; (2) liquidity, defined as the ratio of liquid assets over total assets; (3) profitability, measured by the return on assets; (4) the ratio of risk weighted assets over total assets; and (5) "excess capital," that is, capital adequacy ratio (*CAR*) minus capital requirement (*KR*).

7. Table 1 reports ordinary least squares estimates for specification (1) for progressively longer straddles around jumps in buffer requirements. Unweighted and weighted regressions are presented in adjacent columns where, in the latter, observations are weighted by bank assets to allow the largest banks to drive the results. In addition to $\Delta KR^i_{t,t-1}$, columns (1) and (2) only include bank and time fixed effects as regressors, while columns (3) and (4) add bank-specific controls, X^i_{t-s}. Subsequently, the period over which credit growth is calculated is progressively lengthened: columns (5)-(6) show the effect of capital on credit growth over a six-month period, from three months before the jump until three months after, while the effect over a one-year period straddling an increase is reported in columns (7)-(8).

8. Estimates point to a contemporaneous effect of capital on lending that "washes out" very quickly. Columns (1) -(4) reveal that a one percentage point increase in capital requirements is associated with a reduction in loan growth of 4 to 6 percentage points in the same quarter, and that this effect survives the introduction of bank-specific controls. However, columns (5) -(8) show that, for longer periods, the coefficient on ΔKR is not significantly different from zero. This means that, over half a year and more, loan growth does not significantly differ between periods with and without changes in capital requirements. Lengthening the straddle to 6 or 8 quarters— that is, 3 or 4 quarters on either side of a jump—does not change this conclusion.

9. This benign outcome suggests that the cost of raising additional capital was quite low for Peruvian banks. Alternatively, capital requirements may not have been binding and/or credit demand was extremely inelastic, allowing banks to pass on higher costs to borrowers without negatively affecting demand. However, the data reject the former hypothesis (Figure 3), while the literature has shown that, even in the short run, demand for credit tends to be quite elastic (see, for example, Karlan and Zinman, 2013).

Appendix Figure 3. Regressing Actual on Required Capital



Notes: the chart plots average capital requirements and capital held for the 14 banks in the sample, weighted by the assets of each bank.

10. The apparently low cost of adjusting to higher capital levels in Peru may be due to a combination of the early announcement of reforms, the relatively slow speed of implementation, and the high profitability of banks. The reforms were officially announced one year before implementation started, allowing banks time to prepare. Implementation was spread over four years, allowing for a smooth adjustment. Finally, with a weighted average return on equity of around 20 percent (16 percent unweighted), Peruvian banks were highly profitable. While unprofitable banks can improve their capital adequacy only by compressing lending or issuing expensive new equity, highly profitable banks need not resort to either of these options: they can simply retain more earnings, making the transition to higher capital requirements easier, while muting the impact on credit.

Appendix Table 1. OLS Estimates for Specification (1)

Effect of a jump in required buffers on loan growth, in increasing straddles of up to one year around the jump.

Dep. Var.: $\Delta L_{t+r,\, t-s}$	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	1q		1q		2q		4q	
Explanatory variables	$(r,s)=(0,1)$		$(r,s)=(0,1)$		$(r,s)=(1,1)$		$(r,s)=(2,2)$	
$\Delta KR_{t,\, t-1}$	-0.0464***	-0.0584***	-0.0399***	-0.0643***	-0.0090	-0.0545	0.0385	-0.0349
	(0.010)	(0.014)	(0.012)	(0.017)	(0.026)	(0.047)	(0.043)	(0.060)
CAR minus KR, t-s			-0.0011	0.0007	0.0012	0.0018	0.0045	0.0035
			(0.001)	(0.001)	(0.003)	(0.002)	(0.005)	(0.005)
Log Assets, t-s			-0.0811***	-0.0558***	-0.1844***	-0.1443***	-0.2883***	-0.2456***
			(0.021)	(0.016)	(0.049)	(0.031)	(0.084)	(0.068)
ROA, t-s			0.5507	0.2305	0.6754	3.6012*	1.7413	8.0339***
			(0.901)	(1.219)	(1.755)	(1.780)	(2.335)	(2.251)
Liquid / Total Assets, t-s			-0.0087	0.0679	0.0305	0.1088*	-0.0300	0.2057
			(0.060)	(0.055)	(0.073)	(0.059)	(0.148)	(0.120)
RWA / Assets, t-s			-0.0613	-0.0213	-0.1215	-0.1026	-0.2488	-0.2225
			(0.044)	(0.034)	(0.083)	(0.076)	(0.159)	(0.177)
Observations	586	586	581	581	575	575	547	547
R-squared	0.323	0.543	0.423	0.571	0.492	0.625	0.519	0.640
Bank FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Time FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Standard errors	Cluster	Cluster	Cluster	Cluster	Cluster	Cluster	Cluster	Cluster
Weights	No	Yes	No	Yes	No	Yes	No	Yes
Adj. R-squared	0.2436	0.4900	0.3491	0.5157	0.4197	0.5711	0.4478	0.5868

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Appendix VII. Report on the Observance of Standards and Codes—Basel Core Principles for Effective Banking Supervision

1. **This assessment of the implementation of the BCP in Peru has been completed as part of the Financial Sector Assessment Program (FSAP), jointly undertaken by the IMF and the World Bank in 2017.** The assessment reflects the regulatory and supervisory framework in place as of the completion of the assessment. It requires a review not only of the legal framework, but also a detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision. It is not intended to analyze the state of the banking sector or crisis management framework, which are addressed by other assessments conducted in this FSAP.

A. Information and Methodology Used for Assessment

2. **This assessment was against the standard issued by the Basel Committee on Banking Supervision (BCBS) in 2012.** Since the past BCP assessment, which was conducted in 2011, the BCP standard has been revised. The revised Core Principles (CPs) strengthen the requirements for supervisors, the approaches to supervision, and the supervisors' expectations of banks through a greater focus on effective risk-based supervision and the need for early intervention and timely supervisory actions. Furthermore, the 2012 revision placed increased emphasis on corporate governance, and supervisors conducting sufficient reviews to determine compliance with regulatory requirements, and having a thorough understanding of the risk profile of banks and the banking system. This assessment for Peru was thus performed according to a significantly revised content and methodology, compared to the previous BCP assessment carried out in 2011.

3. **The Peruvian authorities opted to be assessed against both the essential criteria (EC) and the additional criteria (AC),** but graded based on EC only. To assess compliance, the BCP Methodology uses a set of EC and AC for each principle. The EC set out minimum baseline requirements for sound supervisory practices. The AC are recommended as the best practices against which the authorities of some more complex financial systems may agree to be assessed and graded. Peruvian authorities chose to be graded against the EC only.

4. **Grading is not an exact science and the CPs can be met in different ways.** The assessment of compliance with each principle is made on a qualitative basis. Compliance with some criteria may be more critical for effectiveness of supervision, depending on the situation and circumstances in each jurisdiction. Emphasis should be placed on the comments that accompany each CP's grading, rather than on the grading itself.

5. **The team appreciated the very high quality of cooperation received from the Superintendencia de Banca y Seguros del Perú (SBS).** The team extends its thanks to the SBS staff who provided excellent cooperation, including extensive provision of documentation and access and for facilitating meetings with other stakeholders. In particular, the team would like to

thank the SBS staff who responded to the extensive and detailed requests promptly and accurately during the assessment.

B. Preconditions for Effective Bank Supervision

6. An effective system of banking supervision needs to be able to develop, implement, monitor, and enforce supervisory **policies under normal and stressed conditions.** There are several elements or preconditions that are necessary for effective supervision:

- ***Sound and sustainable macroeconomic policies:*** See the section 'The Macrofinancial Context' in this report.

- ***A well-established framework for financial stability policy formulation:*** See the section 'Macroprudential Framework and Policies' in this report.

- ***A well-developed public infrastructure:*** The General Financial System Law (LGSF) provides the SBS the mandate for financial sector supervision. The SBS issues the accounting rules and establishes the structure of the financial statements of financial institutions. The issued accounting standards are based (with some minor deviations) on the International Financial Reporting Standards (IFRS). The SBS also establishes the external audit requirements for supervised institutions, which are based on the International Standards on Auditing and Related Services issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). The Securities Market Superintendence (SMV) is the government entity in charge of regulating and supervising securities market and security settlement systems, while the Central Bank regulates payment systems. The National Institute for the Protection of Competition and Copyright (INDECOPI) is responsible for protecting the rights of consumers and ensuring the adequacy of financial services based on the information provided, amongst other functions. Finally, the SBS, as established by the LGSF, manages a well-established Risk Registry. The Risk Registry is an integrated system for registering financial, credit, commercial and insurance risk, containing information on debtors of the supervised institutions. The Risk Registry provides global and systematised information to third parties, such as the commercial credit registries (thus becoming one of the sources of information of these registries), and individually to information owners, but also plays a key role in SBS' credit risk supervision.

- ***A clear framework for crisis management, recovery and resolution:*** See the section 'Financial Safety Net and Crisis Management' in this report.

- ***Appropriate level of systemic protection (or public safety net):*** See the section 'Financial Safety Net and Crisis Management' in this report.

- ***Effective market discipline:*** In addition to the disclosure requirements established by the SBS, the commercial banks (which are by Law required to be listed), are also subject to the disclosure requirements of the SMV, which include also the requirement to publish annually (as an appendix to the annual report) a self-assessment against the Corporate Governance Code. The required disclosures are published and accessible on the SMV website.

C. Main Findings

Responsibilities, Objectives, Powers, Independence, and Accountabilities (CPs 1–2)

7. SBS responsibilities, objectives and powers are clearly defined albeit impaired by legal limitations regarding consolidated supervision. SBS is the banking supervision authority in Peru and it has all the necessary powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. A significant shortcoming, nevertheless, is that its supervisory powers are limited regarding direct access to parents and affiliates, including non-financial subsidiaries and other affiliates of the parent, all being outside of the direct supervisory perimeter. To redress the absence of this power, the SBS is working through the licensed subsidiaries in Peru and using its powers to put limitations on the licensed institutions if it observes weaknesses on a group level. However, the regulations imposed through this approach on financial groups, for which the SBS has assumed the role of home supervisor, are not as comprehensive (in particular regarding corporate governance and risk management) as the regulations for the licensed entities. These observed weaknesses in the regulatory framework for the supervision of financial groups, for which the SBS is or has assumed the role of home supervisor, have as a root cause the absence of adequate powers to include holding companies and affiliates in the scope of supervision.

8. SBS has operational independence and no budget constraints, however, further enhancements in terms of legal protection and accountability would be beneficial. Legal protection should be enhanced as current provisions extend only to the Superintendent and Deputy Superintendents and even in those cases covering only the first five years after they have left office. Governance and accountability arrangements have further room for improvement, particularly regarding the assessment of the effectiveness of supervisory activities and further disclosure to the public. This will require enhanced transparency of supervisory actions beyond the issuance of annual reports. Allocation of resources within banking supervision does consider the risk profile and systemic importance of individual banks, although the proportion of staff allocated to banks and banking groups, in comparison to the microfinance institutions might need to be reevaluated.

Cooperation, Consolidated Supervision and Home-Host Relationships (CPs 3, 12 and 13)

9. Cooperation and collaboration arrangements with local and foreign authorities are in place. Arrangements currently in place in Peru provide a framework for cooperation and collaboration with relevant domestic and foreign supervisors and do reflect the need to protect confidential information. SBS seems to be actively engaged in cross-border cooperation, including exchanges of information and cooperation on examinations, even beyond its supervisory powers. Particularly regarding domestic authorities, SBS does not seem to feel the need to exchange much information to perform its supervisory duties, although providing information as requested.

10. Consolidated Supervision is a priority for SBS, albeit impaired by the legal framework. Given the legal limitations, SBS has done a remarkable job over recent years in terms of gathering information on the conglomerates, monitoring their activities and requiring, by enforcing through the supervised entities and moral suasion, prudential requirements and controls, and to a certain extent, also acting as a "de facto" home supervisor. The lack of legal enforceability of supervisory requirements directly to the holding company and the existence of non-negligible cross-border operations (and considering that one of the financial groups has the strategy to look for expansion opportunities abroad), outside the direct supervisory perimeter are issues of concern. The fact that the holding company can have all types of investments in non-financial entities and its risk management and controls are not under the formal scrutiny of the SBS are also reasons for concern, even if the investments are deducted from the regulatory capital at the financial group level. Moreover, its supervisory approach to the group-level assessment of governance, risk management, capital adequacy and liquidity risk management needs enhancement.

Permissible activities, Licensing, Transfer of Ownership and Major Acquisitions (CPs 4 to 7)

11. SBS has a thorough authorizations regime, which would benefit from a few enhancements. Market entry is highly controlled and SBS does overall perform a thorough job in reviewing information provided for authorizations purposes. SBS has the power to review, reject and impose prudential conditions on proposals for transfer of significant ownership or controlling interest above 10 percent held directly or indirectly in existing banks to other parties. The legal and regulatory framework falls short in using the concept of significant influence as a qualitative indicator for significant ownership, which would encompass situations where in practice there is significant influence on the management or policies of the bank, even in situations of stakes below 10 percent. The SBS has the power to approve or reject major acquisitions or investments by a bank including establishment of cross-border operations. The limit established for investments in publicly traded companies (no more than 50 percent of the invested company, up to 10 percent of regulatory capital), nevertheless, might result in banks having high stakes and controlling interest/influence in non-financial companies.

Ongoing Supervision (CPs 8-10)

12. The SBS has a robust supervisory approach, moving towards a more risk-based framework. The supervisory approach is supported by a rating methodology that encompasses a forward-looking perspective, assessing and addressing risk emanating from banks and the banking system. Elements related to conglomerates of which a licensed institution is part are taken into account for overriding purposes, but are not embedded into the rating. SBS seems to have a deep knowledge of the operations and risk profile of the major banks operating in Peru, making effective use of a broad range of information sources. Interactions with senior management and board have been enhanced but there is still room for further improvement. Resolvability of banks is a topic yet to be tackled by SBS.

13. A broad range of techniques and tools, supported by a broad set of information and prudential reports, enable the implementation of the supervisory approach. The integration of its on and off-site activities has been beneficial and the split between a specialized risk Deputy Superintendence (SAR) and another one (SABM) in charge of individual banks seems to be working well. In addition to the on-site examinations, SBS produces an array of reports produced by both Superintendences, sometimes with overlap between them. Off-site surveillance is yet to acquire a platform similar as for the on-site activities, facilitating analysis and monitoring of follow up activities.

Corrective and Sanctioning Powers (CP 11)

14. Early action and moral suasion play an important role in SBS effectiveness. The broad powers granted by the legal framework, paired with a moral suasion culture have enabled SBS to successfully tackle supervisory concerns, acting at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. SBS has experienced senior staff that ensure consistency in the application of the corrective actions. SBS would benefit, nevertheless, from written procedures operationalizing its broad legal powers into a range of supervisory tools to be systematically applied depending on the severity of the situation.

Corporate Governance and Risk Management (CPs14–15)

15. The SBS issued in 2017 a new Corporate Governance and Risk Management Regulation incorporating the main elements of the Basel Corporate Governance Principles for Banks. In its regulatory and supervisory framework, the SBS puts significant emphasis on risk management and corporate governance of the licensed institutions and sets clear expectations regarding the role and responsibilities of the Board and the structure of its committees. However, the actual engagement with the Board and individual Board members could be intensified as it is currently mainly limited to an annual meeting with one of the independent Board members.

16. The essential criteria for the evaluation of corporate governance apply explicitly to banks and banking groups. SBS' governance and risk management regulation does not apply on a group-level for institutions for which the SBS is the home supervisor. As a result, the individual group Board members are not subject to a formal fit and propriety review by the SBS, group Board members are not required to sign-off on their responsibilities as required for Board members of supervised institutions, and the supervisory approach to corporate governance on a group-level is less developed. As mentioned, the root cause of the indirect supervision and less comprehensive regulatory framework for financial groups for which the SBS is the home supervisor, results from its limited powers in this regard.

17. The Consolidated Supervision Regulation to a certain extent redresses the fact that the risk management regulations do not apply on a group-wide basis. The Consolidated Supervision Regulation requires the licensed institution to assure that the group has adequate risk management frameworks in place. This indirect form of regulation and supervision seems currently to work, because the main activities of the Peruvian conglomerates are still taking place in Peru.

However, this approach is not optimal and might become ineffective when the cross-border activities of these groups increase.

Capital Adequacy (CP 16)

18. The SBS has made significant progress on the implementation of the Basel III regulatory reform agenda. Although there are differences in the implementation, in particular regarding the different capital buffers, the implemented approaches aim to achieve the same objectives and broadly equivalent overall capital levels. Apart from introducing the Basel III capital definition and formally incorporating the supervisory review of the Internal Capital Adequacy Assessment Process (ICAAP) into account in SBS' internal rating methodology, there are other elements that could be improved. For example, the countercyclical buffer is activated if GDP growth is above 5 percent, which may be not effective in situations where there is excessive credit growth when GDP growth is still below 5 percent. In addition, the systemic risk and single name risk buffers need to be reviewed as they are currently not commensurate with the risk they are supposed to cover. These issues have already been identified by the SBS and are part of the review of the Additional Capital Requirements Regulation that is currently taking place.

19. The supervisory group capital adequacy assessment needs enhancement. The group capital adequacy assessment could be further enhanced by also taking into account: i) the capital adequacy of the holding company on a solo level (in order to determine if the excess capital is available on a holding company level); ii) the location of capital within the conglomerate, including the risk of ringfencing/non-transferability of capital allocated to entities supervised by authorities abroad; iii) the extent to which excess capital at a group level can be completely allocated to support the financial activities of the conglomerate. The assessment of the consolidated capital adequacy does not take adequately into account the necessary adjustments to account for the change in accounting standards; solo financials based on SBS accounting standards, while consolidated financials might be based on IFRS (which could impact the provisioning levels and therefore the available capital on a consolidated basis).

Prudential Regulations and Requirements (CP17–CP25)

20. The regulatory and supervisory approach and practices regarding the other prudential regulations and requirements are in general sound. As observed in the 2011 BCP assessment, the market risk regulation is outdated. The SBS has recently issued a revised regulation for consultation to the industry, which when issued should bring this regulation again in line with international standards.[1] In practice the outdated regulation has not constrained the SBS in conducting effective supervision. With regard to liquidity, the SBS has implemented the LCR (tailored to the local circumstances) and is in the process of implementing the NSFR. With the revised liquidity risk management regulation issued in 2012, the SBS also requires groups for which it acts as the home supervisor, to have liquidity contingency plans on a group level. While the revised regulation

[1] After the completion of the assessment (November 1, 2017) the SBS issued the revised market risk regulation (Resolution SBS No. 4906-2017) on December 20, 2017.

requiring liquidity contingency plans on a group level has been issued in 2012, the actual development of these plans is still in their initial phase.

Internal Control, Internal and External Audit, Financial Reporting and Disclosures (CP2628)

21. The regulatory and supervisory frameworks for internal control, audit and financial reporting and disclosures are adequate. Regarding disclosures, the SBS could further improve the qualitative disclosures by implementing the recommendations of Enhanced Disclosure Task Force of the Financial Stability Board and/or the implementation of Pillar 3. The SBS could also improve its engagement with the external auditors. In addition, it could assess more in depth whether the current provisioning requirements are adequate when compared with the new IFRS9 standard, while also considering possible issues as a result of the widening gap in accounting standards between supervised institutions (SBS standards) and consolidated financial groups (might be based on IFRS standards). Overall the frameworks covering these principles are considered adequate taking into account the current state of development and complexity of the financial markets and banking system.

Abuse of Financial Services (CP 29)

22. SBS has a robust AML/CFT framework, but the limited sanctions can potentially curb its effectiveness. The regulatory and supervisory framework has been strengthened in recent years with the issuance of the AML/CFT risk management regulation and continuous enhancements in supervisory procedures. An important limitation in the current framework is the fact that sanctioning for banks is confined to fines up to $ 250,000, not enough to curb behavior.

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
1. Responsibilities, objectives and powers	SBS responsibilities and powers are clearly defined in the legal framework. Overall, SBS has powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. A significant shortcoming, nevertheless, in the Peruvian legal framework is that its supervisory powers are limited regarding direct access to parents and affiliates, including their subsidiaries all being outside of the direct supervisory perimeter. Such legal limitation is particularly of concern since two Peruvian (in terms of main shareholders, activities and management) conglomerates with foreign holding companies, for which the SBS is operating de facto as the home supervisor, are systemic. Although the SBS has done a remarkable job over the recent years in terms of gathering information on the conglomerates, monitoring their activities and requiring (by enforcing through the supervised entities and moral suasion) prudential requirements and controls, these legal limitations impair SBS' ability to effectively regulate and supervise these conglomerates on a consolidated basis.
2. Independence, accountability, resourcing and legal protection for supervisors	SBS has operational independence, accountability and governance arrangements in place and publicly disclosed. It has also no budged constraints. Allocation of resources do consider the risk profile and systemic importance of individual banks although the proportion of staff allocated to banks and banking groups, in comparison to the microfinance institutions seems too low. Legal protection should be enhanced, nonetheless. Current provisions do provide certain level of protection but SBS and SBS staff liability are not shielded through a "good faith" test. In addition, current provisions fully extend only to the Superintendent and Deputy Superintendents and even in those cases covering only the first five years they have left office. Governance arrangements have further room for improvement, particularly regarding the assessment of the effectiveness of supervisory activities. In addition, the fact that the Superintendent mandate coincides with the constitutional term of the government may potentially undermine his/her personal autonomy.
3. Cooperation and collaboration	Arrangements currently in place in Peru provide a framework for cooperation and collaboration with relevant domestic and foreign supervisors and do reflect the need to protect confidential information. Particularly regarding domestic authorities, SBS does not seem to feel the need to exchange much information to perform its supervisory duties, although providing information when requested.
4. Permissible activities	The permissible activities of institutions that are licensed, and subject to supervision as banks operating in Peru, are clearly defined and the use of the word "bank" in names is controlled.
5. Licensing criteria	SBS has a sound and comprehensive licensing process in place, encompassing the assessment of the ownership structure and governance, strategic and operating

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	plans, internal controls, risk management and projected financial conditions. A non-objection is required in cases where the parent is a foreign bank.
6. Transfer of significant ownership	SBS has the power to review, reject and impose prudential conditions on proposals to transfer significant ownership or controlling interest above 10 percent held directly or indirectly in existing banks to other parties. The legal and regulatory framework falls short with regard to significant influence, which would encompass situations where in practice there is significant influence on the management and policies of the bank even in situations with stakes below 10 percent.
7. Major acquisitions	The SBS has the power to approve or reject major acquisitions or investments by a bank including establishment of cross-border operations. The limit established for investments in publicly traded companies (not higher than 50 percent of the invested company) might result in banks having high stakes and controlling interest/influence in non-financial companies.
8. Supervisory approach	The SBS has a sound and comprehensive supervisory approach, moving towards a more risk-based framework. It is supported by a rating methodology and encompasses a forward-looking perspective, assessing and addressing risk emanating from banks and the banking system. Elements related to the conglomerate are taken into account for overriding purposes, but are not embedded into the supervisory rating methodology. SBS seems to have a deep knowledge of the operations and risk profile of the major banks operating in Peru, making effective use of a broad range of information sources. Interactions with senior management and board have been enhanced but there is still room for further improvement. Resolvability of banks is a topic yet to be tackled by SBS.
9. Supervisory techniques and tools	SBS has a broad range of techniques and tools to implement its supervisory approach. The integration of its on and off-site activities has been beneficial and the split between a specialized risk Deputy Superintendence and a Superintendence in charge of the general supervision of individual banks seems to be working well. In addition to the on-site examinations, SBS has an array of reports produced by both Superintendences, sometimes with overlap between them. Off-site surveillance is yet to establish a platform similar as for the on-site activities, facilitating analysis and monitoring of follow-up activities.
10. Supervisory reporting	The SBS collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through on-site examinations.
11. Corrective actions and sanctioning powers of supervisors	SBS does effectively act at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The broad powers granted by the legal framework, paired with a moral suasion culture have enabled SBS to successfully tackle supervisory concerns. SBS has experienced senior staff that ensure consistency in the application of the corrective actions. Nonetheless, SBS would benefit from documenting the in practice used operational procedures and framework for corrective actions, to provide further assurance on its consistent application.

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
12. Consolidated supervision	The legal framework in Peru empowers SBS to exercise full consolidated supervision only from the licensed bank downwards. Holding companies of the banks are not formally regulated or supervised. The vast majority of foreign exposures are, however, held through holding companies. By enforcing through the supervised entities and moral suasion, SBS has been able in recent years to gather information on the conglomerates, monitoring their activities and requiring prudential requirements and controls. To a certain extent SBS acts "de facto" as the home supervisor and systematically conducts examinations of financial subsidiaries of the holding company (in relation to which it has no formal supervisory powers). However, weaknesses remain with regard to the supervisory approach on a group-level to governance, risk management, capital adequacy assessment and liquidity risk management.
13. Home-host relationships	SBS is actively cooperating with home and host supervisors. Cross-border operations are concentrated in the two systemic conglomerates and represent almost 22 percent of gross total assets. Although from a legal perspective the vast majority of those operations are outside the supervisory perimeter (investments through the holding company), SBS acts de facto as the home supervisor. None of the foreign operations are material from a host supervisor perspective. The SBS has not established Crisis Management Groups for the two Peruvian financial conglomerates.
14. Corporate governance	SBS' governance requirements do not apply on a group-level for institutions for which the SBS act as the home supervisor. As a result, the individual group Board members are not subject to a formal fit and propriety review by the SBS, group Board members are not required (GIR, article 9) to sign-off on their responsibilities as required for Board members of supervised institutions, and the supervisory approach to corporate governance on a group-level is less developed. In its regulatory and supervisory framework, the SBS puts significant emphasis on corporate governance of the licensed institutions and sets clear expectations regarding the role and responsibilities of the Board and the structure of its committees. However, the actual engagement with the Board and individual Board members could be further enhanced as it is currently not commensurate with the emphasis placed on it by the regulation and SBS' governance expectations. In addition, the requirements regarding the composition of the committees (number of independent Board members and having an independent Board member as Chair) could be further aligned with the Basel Corporate Governance Principles issued in July 2015. The new Corporate Governance & GIR (coming into effect per April 1, 2018) sets the expectation of a periodic Board effectiveness self-assessment. However, the SBS has not yet developed a clear expectation with regard to the standards of such an assessment, an internal framework for assessing the collective suitability and effectiveness of the Board, and assessment criteria, in terms of expected seniority and experience, for key Board positions. Intensified engagement with Board members will

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	help to develop a more comprehensive view of the composition and the effectiveness of the Board (currently mainly based on the review of Board and Committee minutes). One way to intensify the engagement would be to invite new Board members (or at least key Board members or Board members of systemically important institutions) for a meeting/interview upon appointment. This would give the SBS the opportunity to convey its expectations and at the same time allow to gauge the Board member's experience and maintain SBS' view on the collective suitability up to date. The assessors note that per the regulation independent Board members at a group level, can also act as independent Board members at a subsidiary level. This dual position could in certain situations, however, result in divided loyalties.
15. Risk management process	The regulatory framework for risk management is tailored to the specific economic circumstances in Peru, and sets clear risk management expectations for material risks to which the banking sector is exposed. Although the Consolidated Supervision Regulation to a certain extent redresses the fact that the risk management regulations (GIR and its successor Corporate Governance & GIR) do not apply on a group-wide basis, the resulting indirect form of regulation is not optimal. The SBS in practice reviews models (country risk, internal rating and credit scoring models and methodologies, etc.) used by Financial Institutions (FIs), however, its regulatory framework could be further enhanced by providing model governance guidelines and expectations. The SBS is currently working on proposal to establish guidelines for model governance. This regulation will include guidelines related to: i) relationship between model management and risk appetite; ii) responsibilities in model management; iii) development, validation, approval and monitoring processes; iv) supporting documentation; and, v) processes of outsourcing and system support. This regulation would further enhance the regulatory risk governance framework. There are currently no formal requirements for recovery and resolution plans for D-SIBs; however, FIs are required to have capital and liquidity contingency plans, taking into account their stress-testing results. These contingency plans provide the D-SIBs with a good starting point for developing recovery and resolutions plans.
16. Capital adequacy	The SBS has made significant progress on the implementation of the Basel III regulatory reform agenda. Although there are differences in the implementation, in particular regarding the different capital buffers, the implemented approaches aim to achieve the same objectives and broadly equivalent overall capital levels. ICAAP and its supervisory review are not yet integrated in SBS' rating methodology, but if needed taken into account as an override on the internal rating. A revised rating methodology which will include the results of the SREP is planned to be rolled-out in 2019.

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	The activation trigger of countercyclical buffer is based only on GDP growth and may be not effective in situations where there is excessive credit growth when GDP growth is below 5 percent. The systemic risk and single name risk buffers need to be reviewed as they are currently not commensurate with the risk they are supposed to cover. These issues have already been identified by the SBS and are part of the review of the Additional Capital Requirements Regulation that is currently taking place. The supervisory group capital adequacy assessment could be improved by also taking into account: i) the capital adequacy of the holding company on a solo level (in order to determine if the excess capital is available on a holding company level); ii) the location of capital within the conglomerate, including the risk of ringfencing/non-transferability of capital allocated to entities supervised by authorities abroad; and iii) the extent to which excess capital at a group level can be completely allocated to support the financial activities of the conglomerate. The assessment of the consolidated capital adequacy does not take adequately into account the necessary adjustments to account for the change in accounting standards; solo financials based on SBS accounting standards, while consolidated financials might be based on IFRS (for groups which holding company's financial statements are prepared in accordance with the IFRS), which could impact the provisioning levels and therefore the available capital on a consolidated basis.
17. Credit risk	The SBS has an adequate regulatory and supervisory framework for credit risk. The Credit Risk Management Regulation issued in 2011 and the Credit Risk Capital Requirements Regulation (Resolution SBS No. 8548-2012) address the comments made in the 2011 BCP assessment.
18. Problem assets, provisions, and reserves	The LGSF and regulations issued by the SBS provide a detailed framework for the identification and management of problem assets, the asset classification, provisioning and write-offs. The corresponding supervisory approach and practices to assure adequate policies and practices by FIs are sound. Reviewed documentation evidenced that in case the SBS observes deficiencies or weaknesses, supervisory action is undertaken. The Credit Conversion Factor (CCF), as used for provisioning purposes, for undisbursed granted credits and unused lines of credit deviates from the factors used for the credit risk capital requirements (Resolution SBS No. 14354-2009, which incorporates CCFs based on the Basel II capital requirements for credit risk). The Basel II framework establishes that commitments with an original maturity up to one year and commitments with an original maturity over one year will receive a CCF of 20 percent and 50 percent, respectively. Only commitments that are unconditionally cancellable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, will receive a 0 percent credit conversion factor. The assessors observe (as a relatively minor issue) that the current blanket approach of assigning a 0 percent CCF for

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	provisioning purposes to all undisbursed and unused lines of credit is less conservative.
19. Concentration risk and large exposure limits	The SBS issued new rules on related parties and economic groups in 2015 (Resolution SBS N° 5780-2015). The new regulation establishes stricter criteria for determining a linkage and adopts international standards for defining an economic group. The regulations do not consider a combined limit for large exposures, however, the large exposure limit (at a maximum 10 percent for uncollateralized exposures) is conservative compared to international standards. In addition, the SBS requires under the Additional Capital Requirements Regulation additional capital for single name concentration risk considering the top 20 exposures. This additional capital charge may not be significant, but has resulted in explicit attention to this risk in FIs' risk management and ICAAPs. In addition, the SBS is currently reviewing the Additional Capital Requirements Regulation including the adequacy of the capital charge for single name concentration risk (see also CP 16).
20. Transactions with related parties	The SBS issued new rules on related party and economic groups in 2015 (Resolution SBS N° 5780-2015). The new regulation establishes stricter criteria for determining a linkage and adopts international standards for defining an economic group, which also is relevant for determining related parties of FIs and financial conglomerates.
21. Country and transfer risks	The regulatory provisioning requirements for country risk are conservative. Overall the assessors consider the regulatory framework and supervisory approach and practices to country risk adequate.
22. Market risk	Considering the characteristics of the banking system (very limited trading activities), the current regulatory and supervisory framework is broadly adequate. As observed in the 2011 BCP Assessment, the existing Market Risk Management Regulation is outdated (1998). A revised and updated Market Risk Management Regulation has been issued to the industry for consultation. The assessors did not perform an in-depth review of the revised regulation. The Basel Committee is in the process of reviewing whether it will issue a simplified Basel III standard approach for market risk. The SBS should evaluate to what extent the current capital requirements would need to be recalibrated to bring them in line with the Basel III standard and whether the Basel III (simplified) standardized approach should be adopted.
23. Interest rate risk in the banking book	The overall regulatory and supervisory approach and practices are adequate. Apart from the risk management requirements, IRRBB is also included in the Additional Capital Requirements Regulation; requiring an additional capital buffer if the change in the Economic Value of Equity (EVE) is more than 15 percent of regulatory capital when applying a per maturity bucket a prescribed interest rate shock.
24. Liquidity risk	The SBS has a well-established regulatory and supervisory framework for liquidity risk. With the inclusion of the LCR in 2012, the framework has been aligned with the Basel III framework. The SBS is currently working on the implementation of the NSFR and is already monitoring the banks on this ratio.

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	Apart from performing semi-annual stress-testing and developing a liquidity contingency plan, there are no group level liquidity requirements. Like for capital, the group requirement is indirectly enforced via the licensed institution in Peru. This indirect form of regulation is not optimal. The adoption of group liquidity contingency plans by the two groups for which the SBS acts as the home supervisor is in its initial phase and the SBS only recently has started to push for more progress in this area.
25. Operational risk	The SBS has a sound regulatory and supervisory approach towards operational risk, which is performed by two specialized departments of the SAR.
26. Internal control and audit	The regulatory framework and supervisory approach and practices for internal control and audit are consistent with the scale and nature of the financial system.
27. Financial reporting and external audit	The regulatory and supervisory framework are broadly adequate. However, the SBS could improve its engagement with the external auditors. In addition, it could assess more in depth whether the current provisioning requirements are adequate when compared with the new IFRS9 standard, while also considering possible issues related to the resulting difference in accounting standards (as a result of not implementing IFRS9) between supervised institutions (using SBS standards) and consolidated financial groups (which may use IFRS standards).
28. Disclosure and transparency	The regulatory and supervisory approach and practices for disclosures and transparency is adequate for the level of development of the financial system. The regulatory framework assures that the required disclosures are easily accessible on the website of the SMV. The required annual disclosures are based on IAS1. These disclosures are complemented by quarterly disclosures as required by the SBS. In addition, the SBS publishes detailed quantitative financial information of the supervised entities and the financial markets on its website.
29. Abuse of financial services	SBS has a robust AML/CFT framework, but limited sanctions can potentially curb its effectiveness. The framework has been strengthened in recent years with the issuance of the AML/CFT risk management regulation and continuous enhancements in supervisory procedures. An important limitation in the current framework is the fact that sanctioning for banks is confined to fines up to $ 250,000, not enough to curb behavior. Other aspects for further improvement include: • Banks are not explicitly required to report to banking supervision suspicious activities in cases where such activities/incidents are material to the safety, soundness or reputation of the bank; there is a general requirement to inform major events related to the bank which has never been used; • The current framework regarding CDD does not encompass the overall requirements for banks to develop their own internal policies and criteria, in addition to the detailed requirements aiming at ensuring an effective CDD. • There are no requirements that the CDD management program has, as one of its essential elements, a customer acceptance policy that identifies business relationships that the bank will not accept;

Appendix Table 1. Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	• There are no specific provisions in terms of requiring entities to gather sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; nor for establishing relationships with those that are not effectively supervised by the relevant authorities.

Appendix Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks	
Core Principle	**Recommendation**
Principle 1	• Amend the legal framework to grant SBS powers to exercise full consolidated supervision.
Principle 2	• Amend the legal framework to further protect all SBS staff for acts or omissions in good faith including current and former staff (including senior management) even after leaving the SBS, irrespectively of the number of years of being out of the SBS; • Amend the legal framework so the Superintendence tenure does not coincide with the constitutional term of the government; • Review the allocation of resources to entities in relation to their systemic relevance and risk to ensure optimization of resources; • Enhance the Internal Audit Function, including the establishment of an Internal Audit Committee; • Operationalize the Financial Stability Committee; • Consider further elaborating on the discharge of supervision responsibilities relative to the objectives through the Annual Report.
Principle 6	• Adequately incorporate significant influence as a qualitative indicator for significant ownership in the regulatory framework.
Principle 7	• Lower the maximum percentage allowed to be held on a non-financial company ensuring there is no controlling interest/influence.
Principle 8	• Establish a process for assessing resolvability of systemic banks; • Consider establishing a rating for conglomerates, and establishing a lead supervisor for the conglomerate, responsible for the overall view of operations and risks; • Further enhance interactions with senior management and particularly the Board of supervised entities, within the process of understanding strategy, operations, controls and risks.
Principle 9	• Streamline off-site surveillance report through further coordination between SAR and SABM; • Speed up the process of establishing an off-site surveillance IT platform.

Principle 11	• Operationalize legal powers into a regulation or procedures comprising a range of supervisory tools to be used depending on the severity of the situation, encompassing its full range of powers including withdrawing a license.
Principle 12	• Amend the legal and regulatory framework to enhance SBS' powers and better supporting its supervisory approach to consolidated supervision.
Principle 13	• Establish Crisis Management Groups for the two systemic conglomerates.
Principle 14	• Apply at a group-level, for groups for which the SBS acts as the home supervisor, the same governance and fit and proper requirements as applied to licensed institutions; • Enhance the requirements regarding the composition of the Board committees (number of independent Board members and having an independent Board member as Chair); • Board engagement needs to be further intensified; • The SBS should develop a framework for assessing the collective suitability of the Board and assessment criteria in terms of expected seniority and experience for key Board positions (e.g. Chair, Chair of the Risk Committee, Chair of the Audit Committee).
Principle 15	• Develop and issue guidelines for model governance including the expectation for the Board and senior management to review the limitations and uncertainties relating to the output of the models and the risk inherent in their use; • Implement requirements for recovery and resolution planning for D-SIBs.
Principle 16	• Incorporate as planned ICAAP and the related supervisory review in the revised supervisory rating methodology; • Finalize as planned the review of the current methodology, in particular regarding the countercyclical buffer and single name concentration, for the calculation of the additional capital requirements; • Enhance the group capital adequacy assessment by extending the current approach with the analysis of: i) the capital adequacy of the holding company on a solo level (in order to determine if the excess capital is available on a holding company level); ii) the location of capital within the conglomerate, including the risk of ringfencing/non-transferability of capital allocated to entities supervised by authorities abroad, and; iii) the extent to which excess capital at a group level can be completely allocated to support the financial activities of the conglomerate; • Review and revise the current group capital assessment methodology to assure that the necessary adjustments to account for difference in accounting standards between a solo and a consolidated level are properly taken into account.
Principle 17	• The developed risk-based supervisory cycle for assessing credit risk should be formalized and as planned incorporated in the revised rating methodology and supervisory approach which is expected to be rolled-out in 2019.
Principle 18	• Review the CCFs applied to undisbursed and unused credit lines.

Principle 22	• Issue the revised and updated Market Risk Management Regulation; [2] • Evaluate to what extent the current capital requirements would need to be recalibrated to bring them in line with the Basel III standard and whether the Basel III (simplified) standardized approach should be adopted.
Principle 23	• Review and consider the implementation of the Basel III standards for IRRBB.
Principle 24	• The approach towards liquidity risk supervision of financial groups should be intensified; • Continue the work on the implementation of the Basel III NSFR (tailored to the local circumstances) as planned.
Principle 25	• Follow up on the recommendations (and lead by example) of the industry-wide business continuity stress-test.
Principle 27	• Assess in more depth the potential impact of implementation of IFRS9 on FIs provisioning requirements, in particular to determine whether the current provisioning requirements are sufficiently prudent; • Discuss and engage with the different stakeholders to further on the implementation strategy of IFRS9; • Consider developing a structured (risk-based) approach for conducting trilateral meetings with the external auditor and the FIs to discuss the management letter; • Strengthen the engagement with the external auditor and the audit profession as part of SBS' supervisory approach.
Principle 28	• Consider implementing the recommendations of the Enhanced Disclosure Task Force of the FSB and Pillar 3 of the Basel framework.
Principle 29	Amend the legal/regulatory framework to: • Be able to impose sizable fines to banks. In addition, powers related to the possibility of suspending dividends, restrictions to asset growth, operating in certain business lines and others would be useful tools to support enforcement of banks' compliance with the AML/CFT framework. • Explicitly require banks to report to the SBS suspicious activities in cases where such activities are material to the safety, soundness or reputation of the bank; • Require banks to develop their own internal policies and criteria for CDD beyond what is expressly prescribed in regulation; • Explicitly require entities to gather sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; • Not allow banks to establish relationships with correspondent banks that are not effectively supervised by the relevant authorities; • Require CDD management programs to have a customer acceptance policy that identifies business relationships that the bank will not accept.

[2] The regulation (SBS Resolution No. 4906-2017) has been issued after the assessment and will come into force June 1, 2018.

Authorities' Response to the Assessment

- The SBS appreciates the opportunity to provide comments for this document. The SBS would like to thank the IMF and WB assessors for their full assessment of Peru's compliance with the Basel Core Principles for Effective Banking Supervision as part of the comprehensive Financial Stability Assessment Program.

- The discussions were fruitful with seasoned supervisors. There were many practical ideas and recommendations for improvement, not all of them making their way in this document but all of which will enrich the SBS internal discussion on future developments of the Peruvian banking regulation and supervision.

- Overall, the assessment adequately reflects the current status of the Peruvian regulatory and supervisory frameworks. There is one point of disagreement regarding the grading of Principle 1. The Peruvian Banking Law defines ample legal powers for the SBS to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. The only area where there is some weakness is the limited legal powers for supervising holding companies, which the SBS considers has been over-weighted in the assessment of Principle 1.

- Even though the SBS has not direct powers over holding companies, it has indirect legal powers to require information and impose prudential requirements through the supervised bank. These indirect powers have demonstrated to be effective in the supervision of the two major banking groups. The SBS recognizes there is room for improvement in the legal framework to deal with potential future risks; however, does not consider its current limited legal powers as a major source of risk.

- Finally, as in previous evaluations, the SBS will carefully evaluate the recommendations and develop a plan to continue strengthening the robust regulatory and supervisory framework of the Peruvian Financial System.