INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/335

ECUADOR

FINANCIAL SYSTEM STABILITY ASSESSMENT

September 2023

This paper on Ecuador was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in August 2023.

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PRESS RELEASE

PR23/317

IMF Executive Board Concludes Financial System Stability Assessment with Ecuador

FOR IMMEDIATE RELEASE

Washington, DC – September 21, 2023: The Executive Board of the International Monetary Fund (IMF) concluded the Financial Sector Assessment Program (FSAP) [1] with Ecuador on August 29, 2023 without convening formal discussions. [2] The Financial Sector Stability Assessment [SD1] (FSSA) report was completed on July 31, 2023. The report is based on the work of joint IMF/World Bank FSAP missions to Ecuador during November-December 2022 and April-May 2023.

Ecuador's financial system is dominated by banks and credit cooperatives. While dollarization provides an important anchor for the Ecuadorean economy, systemic liquidity risks are high due to the limited capacity of the central bank to provide liquidity. The financial sector is overall resilient to adverse macrofinancial shocks but some institutions have meaningful solvency and liquidity vulnerabilities. To preserve confidence it is key to enhance capitalization, promptly recognize loan losses, and address unviable institutions.

The FSSA concluded that institutional framework for financial sector oversight is complex, uncoordinated, and prone to political intervention. Reforms are needed to enhance supervisory independence, prioritize safety and soundness, separate prudential supervision from other functions, and substantially strengthen the supervisory approach. The macroprudential framework needs further progress by developing stronger financial sector-wide analytical capacity, improving information sharing and coordination, and clarifying the roles between multiple agencies.

Similarly, the legal framework for bank resolution should be enhanced by establishing clearer responsibilities for the involved agencies, expanding the resolution toolkit, and ensuring that resolution decisions are not reversed. The deposit insurer's access to information and back-up funding should be improved, and the existing arrangements should be reviewed to provide more flexible emergency liquidity assistance. Governance and internal controls of public banks also need urgent strengthening and interest rate caps should migrate to a usury rate.

[1] The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. FSAPs provide input for Article IV consultations and thus enhance Fund surveillance. FSAPs are mandatory for the 47 jurisdictions with systemically important financial sectors and otherwise conducted upon request from member countries. The key findings of an FSAP are summarized in a Financial System Stability Assessment (FSSA).

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

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INTERNATIONAL MONETARY FUND

ECUADOR

FINANCIAL SYSTEM STABILITY ASSESSMENT

August 4, 2023

KEY ISSUES

- **Context:** Ecuador's financial system is dominated by banks and credit cooperatives. Its exposure to macrofinancial risks is shaped by its fully dollarized economy and its position as an oil exporter. The institutional framework for financial sector oversight is complex, uncoordinated, and prone to political intervention, which results in sub-optimal policies.
- **Findings:** While dollarization provides an important anchor for the Ecuadorean economy, systemic liquidity risks are high due to the limited capacity of the central bank to provide liquidity. A sharp tightening of monetary policy in the United States, an abrupt slowdown in China, falling oil prices, and political instability could reduce economic activity and impact both asset quality and liquidity of the system. Banks and credit cooperatives have yet to fully absorb pandemic-related credit losses and liquidity conditions have tightened.
- **Policy advice:** Reforms are needed to enhance supervisory independence, prioritize safety and soundness, separate prudential supervision from other functions, and substantially strengthen the supervisory approach. The macroprudential framework needs further progress by developing stronger financial sector-wide analytical capacity, improving information sharing and coordination, and clarifying the roles between the multiple agencies involved. Similarly, the legal framework for bank resolution should be enhanced by establishing clearer responsibilities for the agencies involved, expanding the resolution toolkit, and ensuring that resolution measures are not reversed. The deposit insurer's access to information and back-up funding should be improved and, although dollarization prevents the central bank from providing a full emergency liquidity assistance facility, the existing arrangements should be reviewed to provide more flexible liquidity insurance. Governance and internal controls of public banks need urgent strengthening and interest rates caps should migrate to a usury rate.

Approved By
May Khamis and James Morsink
Prepared By
Monetary and Capital Markets Department

This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Ecuador in December 2022 and April-May 2023. The FSAP findings were discussed with the authorities during May-June 2023.

- The FSAP team was led by Caio Ferreira, IMF, and Douglas Pearce, World Bank, and included Mark Adams (IMF deputy mission chief), Federico Diaz Kalan (World Bank deputy mission chief), Sergei Dodzin, Niels-Jakob Hansen, Carolina Lopes-Quiles, Santiago Texidor Mora, Francisco Vazquez, Caroline Wu (all IMF staff), Luis Martin Auqui, Jose Garcia Barroso, David Hoelscher (IMF external experts), Leyla Castillo, Maria Teresa Chimienti, Pasquale Di Benedetta, Eva Gutierrez, Oliver Masetti, Faruk Miguel, Anderson Caputo Silva, Diego Sourrouille (all World Bank staff) and Antonio Velandia-Rubiano (World Bank external expert). Carol Franco and Srujana Sammeta (IMF) provided administrative support.

- The mission met with senior officials at the Central Bank, Ministry of Economy and Finance, regulatory and supervisory agencies, as well as staff in private and development financial institutions, and several other stakeholders. The team would like to thank the authorities for their hospitality and the excellent cooperation and fruitful discussions.

- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. It is intended to help countries identify key sources of systemic risk in the financial sector and recommend policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational, legal, and risk related to fraud, are not covered in FSAPs.

- This report was prepared by Caio Ferreira and Mark Adams with contributions from the FSAP team.

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APPENDIX

Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
API	Application Programming Interface
AQR	Asset Quality Review
ATM	Automatic Teller Machine
BCBS	Basel Committee on Banking Supervision
BCE	Central Bank of Ecuador
BCP	Basel Core Principles for Effective Banking Supervision
BIESS	Banco del Instituto Ecuatoriano de la Seguridad Social
BIS	Bank for International Settlements
CAR	Capital Adequacy Ratio
CBDC	Central Bank Digital Currency
CCPs	Central Counterparties
CET1	Core Equity Tier 1
CFN	Corporación Financiera Nacional
COMyF	Código Orgánico Monetario y Financiero
CONALAFT	Comité Nacional de Coordinación Contra el Lavado de Activos, el Financiamiento del Terrorismo y la Proliferación de Armas de Destrucción Masiva
COSEDE	Corporación del Seguro de Depósitos
COVID	Coronavirus Disease
DAR	Detailed Assessment Report
Das	Development Agencies
DBs	Development Banks
DIF	Deposit Insurance Fund
DFIs	Development Finance Institutions
DFS	Digital Financial Services
DFS	Development Financial System
D-SIBs	Domestic Systemically Important Banks
ELA	Emergency Liquidity Assistance
EM	Emerging Market
ESG	Environmental, Social and Governance
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
FX	Foreign Exchange
GDP	Gross Domestic Product
GHG	Greenhouse Gas
G-SIB	Global Systemically Important Bank
HHI	Herfindahl–Hirschman index
HQLA	High Quality Liquid Assets

IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISSB	International Sustainability Standards Board
JPRF	Junta of Financial Policy and Regulation
JPRM	Junta of Monetary Policy and Regulation
KA	Key Attribute
LAC	Latin America and the Caribbean
LCR	Liquidity Coverage Ratio
LTV	Loan-to-Value
MCM	Monetary and Capital Markets Department, IMF
MER	Mutual Evaluation Report
MSMEs	Micro, Small and Medium Sized Enterprises
MoU	Memorandum of Understanding
NBFI	Non-Bank Financial Institution
NDC	Nationally Determined Contribution
NGFS	Network for Greening the Financial System
NPL	Nonperforming Loans
NSFR	Net Stable Funding Ratio
OMO	Open Market Operation
P2G	Person to Government
P2P	Person to Person
PD	Probability of Default
POS	Point of Sale
QR	Quick Response
RAM	Risk Assessment Matrix
RoA	Return on Assets
RoE	Return on Equity
RWA	Risk Weighted Asset
SB	Superintendencia de Bancos
SEPS	Superintendencia de Economia Popular y Solidario
SOFI	State-owned Financial Institution
ST	Stress Test
SVCS	Superintendencia de Compañías, Valores, y Seguros
TD	Top-down
UAFE/FIU	Unidad de Análisis Financiero y Económico/Financial Intelligence Unit
WB	World Bank
WEO	World Economic Outlook

EXECUTIVE SUMMARY

The Ecuadorian financial sector has remained stable, and credit continued to grow through the pandemic, but the tightening of global financial conditions presents new challenges. Since mid-2022 credit growth has slowed, and liquidity conditions have tightened considerably. In the first quarter of 2023 real GDP growth moderated to 0.7 percent; coupled with other indicators, this points to a sharp and broad-based slowdown and an increase in downside risks. Higher international interest rates and competition for deposits have increased funding costs which, combined with caps on lending rates, has led to margin compression.

The institutional framework for financial sector oversight is complex and prone to political intervention, which results in sub-optimal policies. The large number of institutions playing a role in financial sector issues puts a premium on effective coordination, which is lacking. Requirements for financial institutions to maintain liquid assets in Ecuador and minimum investments in government securities and public banks at non-market prices facilitate domestic financing to the government at the expense of risk diversification at the systemic level. Interest rate caps hinder financial inclusion and shift credit away from productive purposes.

Stress tests suggest that the financial sector is overall resilient to adverse macro-financial shocks but has institutions with meaningful vulnerabilities. The FSAP considered a scenario of a sharper-than-expected global slowdown and tightening of US interest rates combined with falling oil prices, reflecting risks from Ecuador's fully dollarized economy and its position as an oil exporter. Under stress, 9 out of the 27 banks, mostly small, would present capital ratios below the 9 percent regulatory minimum, although the resulting capital shortfall is small (0.2 percent of GDP in 2025). Losses could be higher if the interest caps on loans do not adjust to reflect funding costs. The stress tests also suggest that the large cooperative sector, which comprises 20 percent of the financial system assets, also has a substantial number of institutions facing asset quality and profitability challenges. It is key to enhance capitalization, promptly recognize loan losses, and address unviable institutions to preserve confidence.

Managing liquidity risk is a critical challenge for Ecuador's financial system. While dollarization provides an important anchor for the Ecuadorian economy, liquidity risks are high due to the limited capacity of the central bank to provide liquidity. Interbank funding markets are thin, and the central bank doesn't offer liquidity facilities. The private liquidity fund offers some liquidity support, but it is limited in size and rarely used. Financial institutions must therefore self-insure against liquidity risk but there are few domestic assets that can be reliably monetized. Liquidity analysis shows that, currently, several important financial institutions do not hold enough liquid assets to comply with international liquidity standards. To reduce financial stability risks, it is key to establish sound liquidity requirements, remove impediments to banks' investments in global liquid assets, reform the liquidity fund, and further develop the interbank and securities markets. These reforms will need to be sequenced carefully in tandem with addressing ongoing fiscal and macroeconomic conditions.

Against this background, it is urgent to improve financial sector supervision. Authorities are committed to strengthen the prudential framework, but institutional shortcomings, insufficiently trained staff, and lack of coordination impair sound supervision. Closing the large gap between current practices and international standards requires a comprehensive plan including actions to:

- **Substantially enhance the technical and analytical capacity of financial sector authorities.** Lack of a career plan and a sound training program and high turnover of staff and management has significantly hindered the acquisition and retention of talent.
- **Set safety and soundness as the primary goal of supervisory agencies.** In practice, agencies often prioritize their broader responsibilities over prudential goals. There is also a need to remove constraints to their independence and enhance their powers, including to facilitate preventative supervisory actions before regulatory breaches.
- **Develop processes, organizational arrangements, and tools to monitor, assess and mitigate systemic risks.** The establishment of a Financial Stability Committee could facilitate these tasks. It is important to clarify macroprudential objectives and functions of the different agencies. Basel III buffers and borrower-based measures should be implemented.
- **Strengthen the supervisory approach.** Examinations and monitoring of individual financial institutions are mostly descriptive. Supervisors need to further focus on risks and be equipped to exercise judgement. Enhanced supervisory plans and guidance, a regular stress testing program, and more attention to climate related risks are also necessary.
- **Enactment of the New Organic Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) Law in line with international standards.** Supervisors and the Financial Intelligence Unit (FIU) also need to be adequately resourced.

Reinforcing the financial sector safety net is also a priority, given the presence of several weak institutions. The supervisory agencies and the deposit insurer should urgently improve their coordination, information-sharing, and joint planning to deal with weak institutions. The legal framework for bank resolution should be updated to expand the resolution toolkit and remove limitations of the existing tools, and deposit insurance payout times should be shortened. The lender of last resort function could be strengthened through reform, although it will remain constrained by dollarization.

Enhancing policies to develop the financial system is also essential.

- To enhance efficiency and impact, public credit support programs should be redesigned, and expectations of debt forgiveness removed. Supervision and enforcement for state-owned financial institutions (SOFIs) needs to be intensified and weaknesses in their balance sheets and operations addressed. Interest rate caps should migrate to a usury rate.
- To develop the capital market, the Ministry of Economy and Finance (MEF) should transition to market mechanisms for placement of government securities and, in subsequent phases, seek to develop the repo and secondary markets and broaden the investor base.

Table 1. Ecuador: 2023 FSAP Key Recommendations		
Recommendations	**Authorities[1]**	**Time[2]**
Systemic Risk and Financial Sector Resilience		
Enhance capitalization, promptly recognize loan losses, and address unviable financial institutions.	SBs, SEPS	I
Improve credit information: (i) transmit data on BIESS to credit bureaus; (ii) grant access to the credit registry data to BCE and SEPS.	JPRF, SB, SEPS, BCE	I
Gradually remove requirements for banks to hold liquid assets domestically.	MEF, JPRF, JPRM	NT
Financial Sector Oversight		
Develop processes, organizational arrangements, and tools to monitor, assess and mitigate systemic risks.	MEF, JPRF, JPRM SB, SEPS, BCE	I
Clarify responsibilities, functions, and powers of different agencies, and consider the establishment of a Financial Stability Committee.	MEF, JPRF, JPRM, SB, SEPS, BCE	NT
Implement Basel III buffers (conservation, countercyclical, D-SIB) and borrower-based measures.	MEF, JPRF, SB, SEPS	NT
Enhance technical and analytical capacity of supervisory agencies by establishing a career plan, sound training program, and adequate resources.	SB, SEPS, MEF, UAFE, CONALAFT	I
Strengthen the institutional framework for supervision by making safety and soundness the primary goal of the superintendencies and enhancing their independence.	MEF, SB, SEPS	MT
Strengthen the supervisory approach, consolidated supervision, and corporate governance requirements and ensure convergence of supervisory and regulatory standards for large cooperatives and both public and private banks.	SB, SEPS, JPRF	NT
Align capital and liquidity requirements with Basel III.	SB, SEPS, JPRF	NT
Improve the legal basis for corrective actions and sanctioning powers.	SB, SEPS, MEF	NT
Ensure timely enactment of the New Organic AML/CFT Law.	CONALAFT	I
Financial Safety Net and Crisis Preparedness		
Separate supervisory and resolution functions and overhaul legal framework for resolution.	MEF, SB, SEPS, COSEDE	MT
Address operational barriers to deposit insurance payout and strengthen COSEDE governance and resources.	MEF, COSEDE	MT
Reform the Liquidity Fund's lender-of-last resort function, including governance and information-sharing, ease of collateral posting, size of the fund, relations with the BCE, and terms of lending.	MEF, COSEDE	NT
Market Development		
Address vulnerabilities in public banks, implement AQR provisioning recommendations, and intensify prudential supervision of SOFIs.	MEF, SB, IESS	I
Redesign credit support programs, remove expectations of debt forgiveness, and migrate interest rate caps to a usury rate.	MEF, JPRM, JPRF	NT
Streamline the supply of government securities and transition to regular auctions, promote the development of the repo and secondary markets and broadening of the investor base.	MEF, JPRF, SB, BCE, SCVS	NT

Notes: 1 All: Ecuadorian financial authorities. Note that the names of responsible agencies are listed in alphabetic order.
2 I: immediate (less than one year), NT: short term (1–2 years), MT: medium term (3–5 years).

BACKGROUND

A. Macrofinancial Context

1. The Ecuadorian economy rebounded after the COVID-19 pandemic but has slowed in 2023. Following a sharp contraction in 2020 as Ecuador was hit by the pandemic and a sharp fall in oil prices and export demand, the economy rebounded (Figure 1). High oil prices have supported Ecuador's external and fiscal balances, with the public sector in 2022 posting the lowest deficit since 2008. However, in the first quarter of 2023 real GDP growth moderated to 0.7 percent; coupled with other indicators, this points to a sharp and broad-based slowdown and an increase in downside risks. Inflation increased in 2022 reaching 3.5 percent (well below regional peers) but has since eased. In December 2022, Ecuador completed a 27-month Extended Fund Facility Arrangement.

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

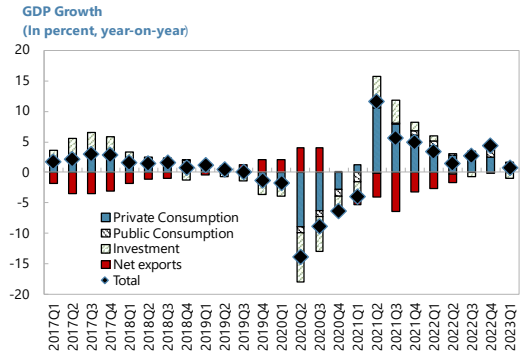
B. Financial Sector Structure and Recent Developments

3. Ecuador's financial sector is dominated by banks and credit cooperatives. The IMF Financial Development Index ranked Ecuador 133 out of 192 countries in 2019, the lowest ranking among peer countries. Financial institutions provide mostly traditional products and there is limited development of services to reach underserved and financially excluded segments. In 2021, 64 percent of adults reported having access to a bank account, below the average for upper middle-income countries (84 percent). Total deposit-takers' assets are around 78 percent of GDP, of which private banks account for over 50 percent (Figures 2 and 3). Credit cooperatives have become increasingly important over the last decade and have total assets of around 20 percent of GDP. In addition, the funds of the social security administration are managed by the Banco del Instituto Ecuatoriano de Seguridad Social (BIESS), the largest financial institution in the country. While BIESS does not take deposits and has not issued other types of liabilities, its mortgage credit portfolio represents about 6 percent of GDP.

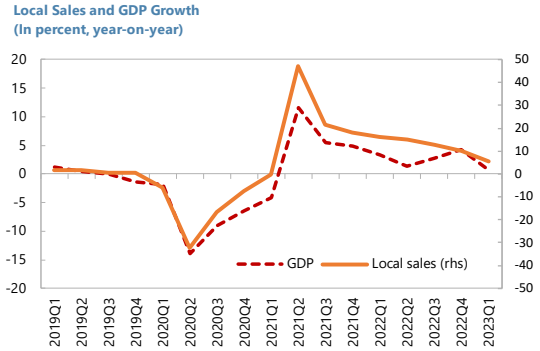
4. Public banks have significantly higher NPLs and have recently undergone an asset quality review (AQR). While public banks have capital ratios above 30 percent covering the substantial gap in loan classification and provisioning found by the AQR in one public bank would trigger supervisory action.

Figure 1. Ecuador: Recent Economic Developments

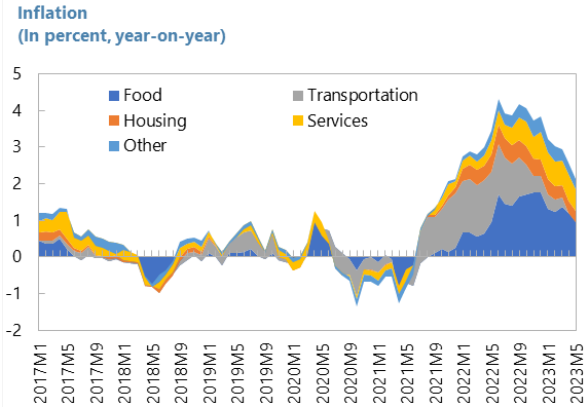
Private consumption has driven the economic recovery…



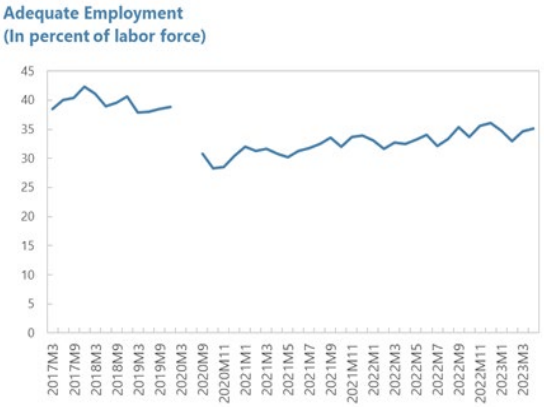
… but high frequency indicators point to moderation in 2023Q1.



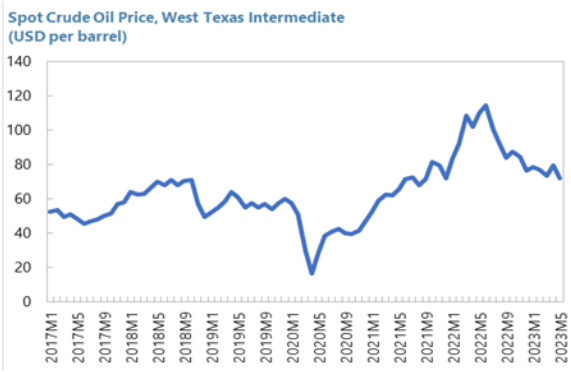
Inflation has peaked and continued to ease.



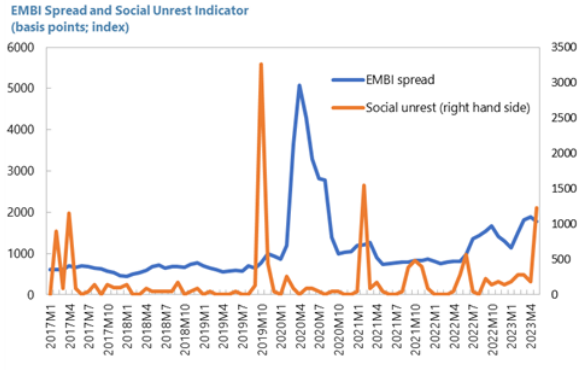
Employment remains below pre-pandemic levels.



High oil prices have strengthened external and fiscal balances, but have recently fallen back…



… and spreads have increased on the back of higher political uncertainty.

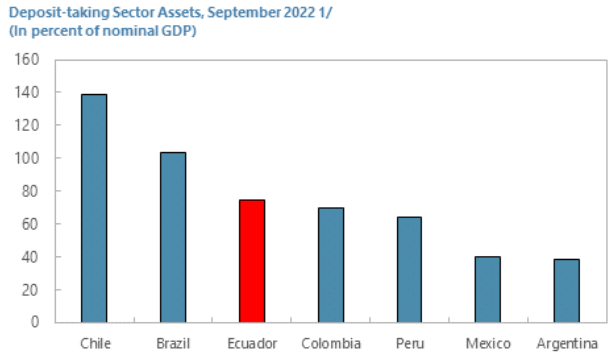


Sources: Servicio de Rentas Internas; Banco Central del Ecuador; Banco Central de la República Dominicana; Organization of the Petroleum Exporting Countries; Barett and others (2022), "Measuring Social Unrest Using Media Reports". *Journal of Development Economics*, 158; IMF staff calculations.

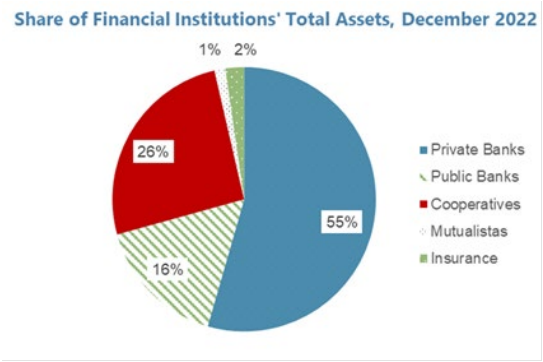
Notes: Local sales is based on administrative tax data. For employment, data is missing during the first two quarters of 2020 due to the pandemic. The EMBI spread is the difference between the weighted average Ecuadorian external debt securities yields and the U.S. Treasury securities yields with similar maturity.

Figure 2. Ecuador: Financial Sector Structure

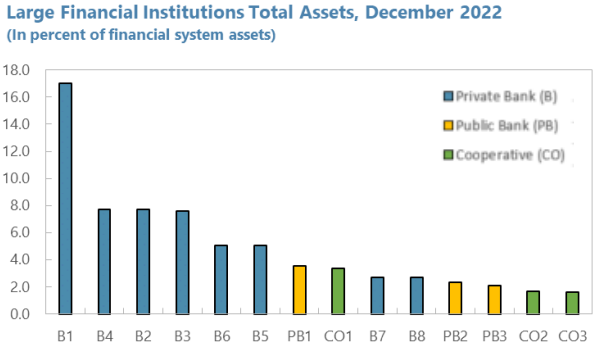
Ecuador's financial system is moderate is size relative to the economy and is in line with the region. 1/



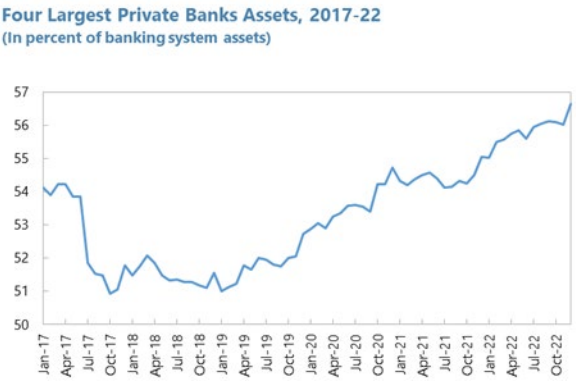
Banks and cooperatives dominate the system, and there is a substantial state-owned sector. 2/



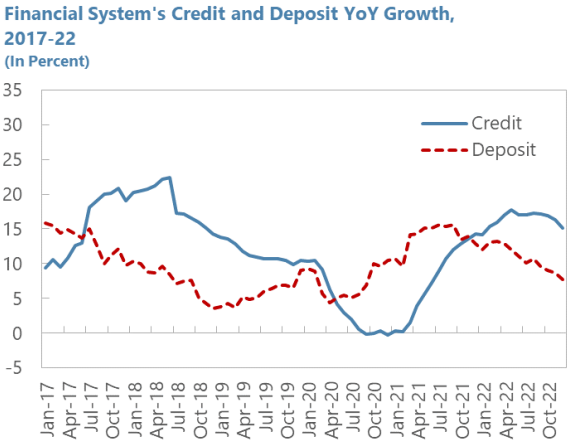
The cooperative sector have become increasingly important over the last decade and the largest cooperatives compete with banks.



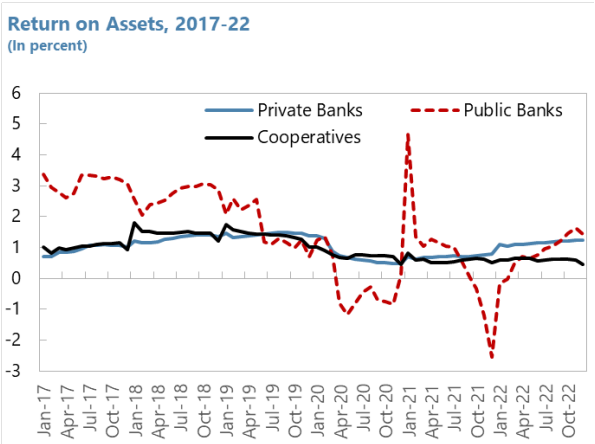
The 4 largest banks represent about 56 percent of deposit takers assets and bank concentration is increasing.



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



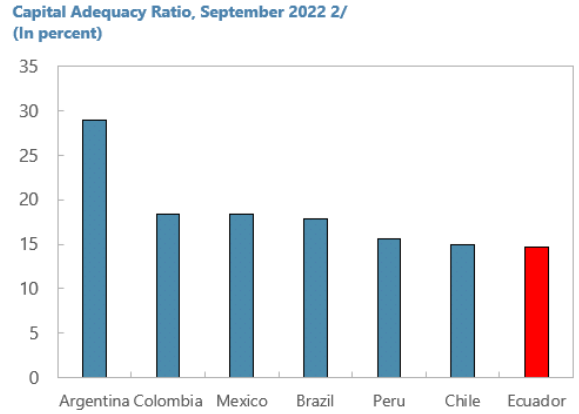
The pandemic and AQR for public banks impacted profitability. The recovery of cooperatives's ROA is lagging. 2/



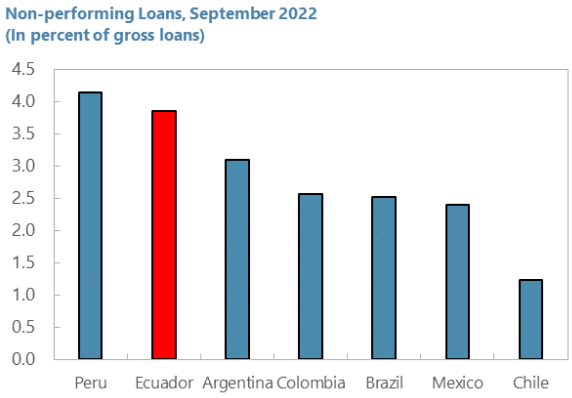
Sources: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria, and staff calculations.
1/ Brazil data is as of 2021: Q3; Chile data as of 2021:M12; Mexico data as of 2021:M5.
2/ Data does not include BEISS. Private banks data include Banco del Pacifico. *Mutualistas* are another form of mutual deposit-taker.

Figure 3. Ecuador: Financial Soundness Indicators

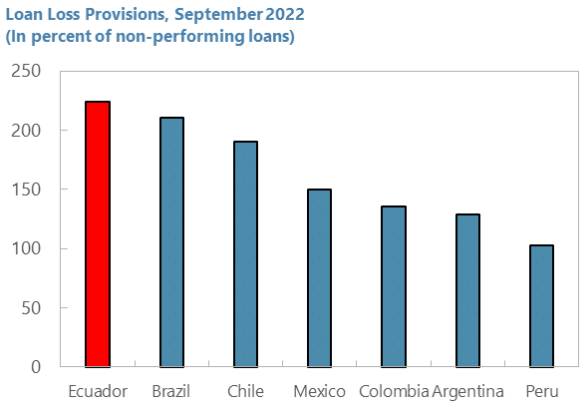
While the aggregate capital ratio is around 15 percent, it is below other countries in the region



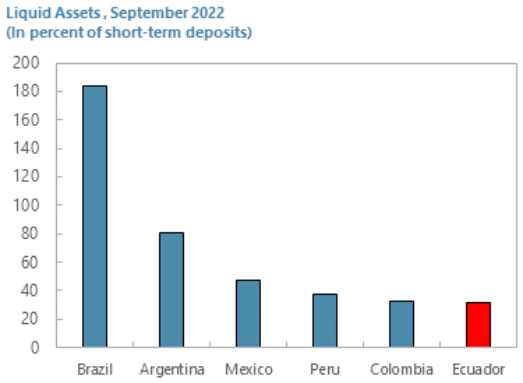
NPLs are comparable to other countries in the region…



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

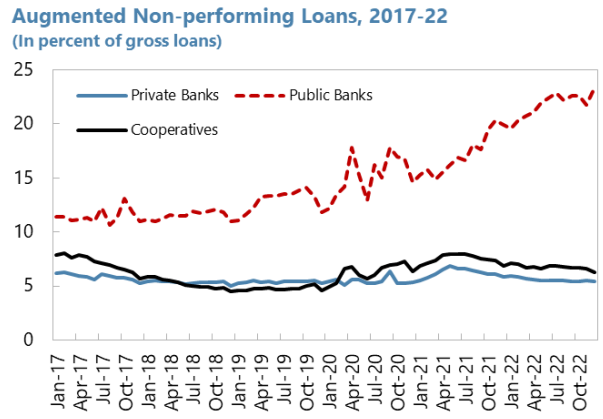


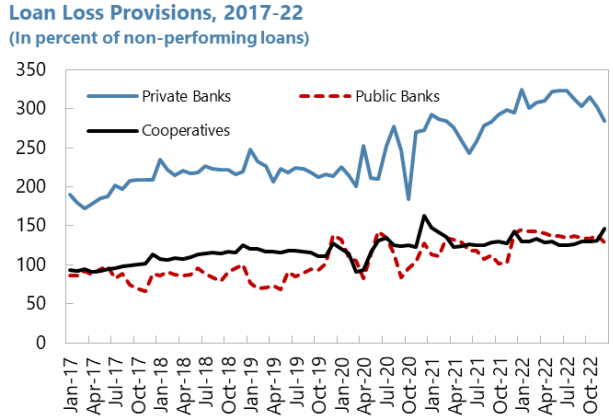
But liquidity indicators appear somewhat weaker…



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

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





Sources: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria, and IMF staff calculations.

[1/] Loan loss provision requirements are specific provisions mostly determined by the number of past due days.

[2/] (For charts 1–4): Brazil data is as of 2021: Q3; Chile data as of 2021:M12; Mexico data as of 2021:M5

5. Financial institutions have sizable inter-connections through deposits and investments. The large banks play a pivotal role in the system, taking deposits and investments from other institutions (Figure 4). Cooperatives are net providers of liquidity to the banking sector, as they place deposits with large and medium-size banks.

C. Financial Repression

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

7. These measures inhibit financial inclusion, distort capital allocation, and elevate financial sector risks. Interest caps prevent lending to new or riskier borrowers and divert resources to consumer lending that is relatively less constrained. Higher international interest rates and competition for deposits have increased funding costs. This, combined with interest rate caps, has led to margin compression and constrained investment. Incomplete credit data, and deficient supervisory practices can also lead to over-indebtedness. Moreover, the requirements for financial institutions to hold liquid assets in Ecuador and public sector securities at non-market prices, limits risk diversification at the systemic level.

D. Liquidity Risk

8. While dollarization provides an important anchor for Ecuador, systemic liquidity risks are high due to the limited capacity of the central bank to provide liquidity. Liquidity shocks affecting banks will ultimately impact the Central Bank balance sheet even though it currently does not offer liquidity facilities, as it will experience an outflow of reserve deposits. This is especially important given the limited size of Ecuador's FX reserves.[1]

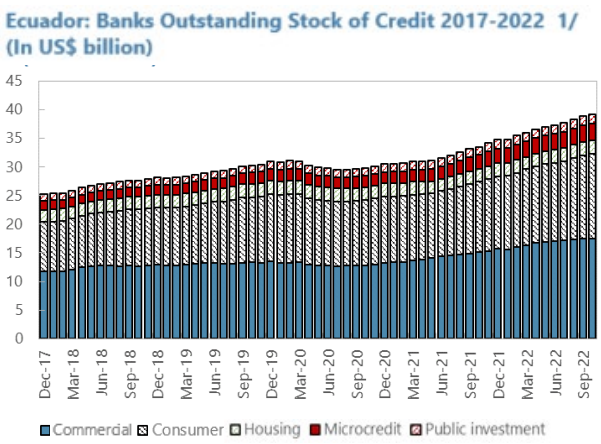
9. Managing liquidity risk is a critical challenge for Ecuador's financial system. There are few truly liquid domestic assets, given the lack of secondary market trading. Interbank funding markets are thin and central bank facilities are absent. The strict prohibition on monetary financing is understood to be a legal impediment for the BCE to accept government securities as collateral. There is an industry liquidity fund, but it is limited in size (about 3 percent of members' assets) and rarely used in part due to its collateralization and operational requirements. Assets that can be

[1] In December 2022, Ecuador's FX reserves were about 35 percent of the IMF's Assessment of Reserve Adequacy metric for emerging markets.

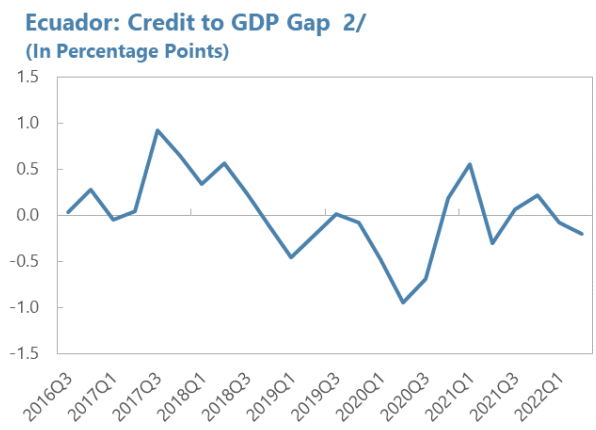
reliably monetized are largely limited to cash, central bank reserves, and foreign securities (and bank deposits for some cooperatives and smaller banks).

Figure 4. Ecuador: Financial Sector Balance Sheet Structure

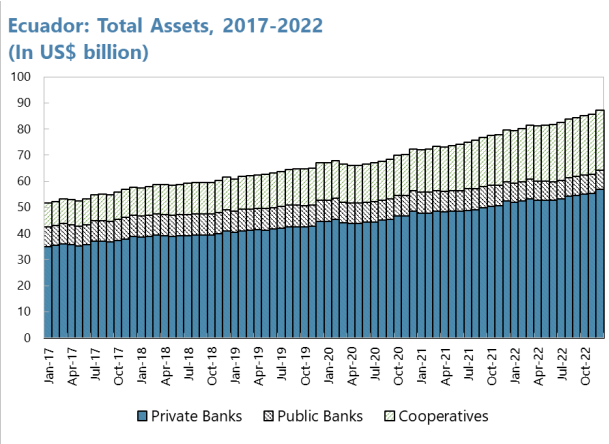
Banks' credit portfolios are mostly commercial and consumer loans; mortgages are relatively immaterial.



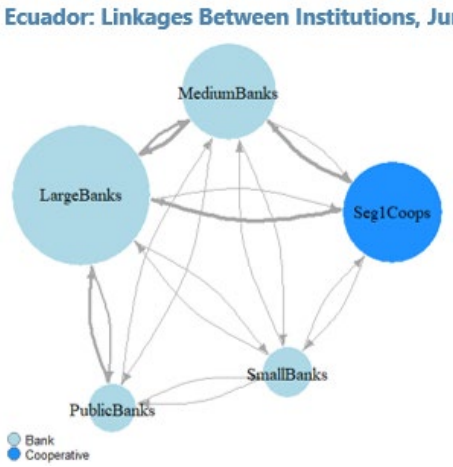
…but overall credit growth has been close to the trend.



Financial system assets are growing, particularly in the cooperatives sector…



Cooperatives are net providers of liquidity to the banking sector.



Sources: Superintendency of Banks, Superintendencia de Economia Popular y Solidaria, and IMF staff calculations.
1/ Lending volumes for private and public banks.
2/ Credit for private banks, public banks and cooperative segments 1–3. Trend calculated using a one-sided HP filter (λ=1600) on quarterly data since 2016Q1.
3/ The diameter of nodes reflects the total assets of the respective institutions. The thickness of the arrows reflects the size of gross-bilateral exposures. The gross bilateral exposures between banks and cooperatives represent 12 percent of total system assets and 9 percent of GDP. Cooperatives are net providers of liquidity to the banking sector, and the large banks play a pivotal role in the system, taking deposits and investments from other institutions. BIESS is excluded.

10. Financial institutions must largely self-insure against liquidity risk. Liquidity analysis indicates that current regulatory requirements do not prevent banks from facing meaningful liquidity risks. The authorities should ensure that financial institutions manage liquidity risk more conservatively than would be necessary in non-dollarized economies and also take steps to expand

the pool of monetizable liquid assets, remove impediments for banks investments in global liquid assets, and ensure that liquid assets held by financial institutions can, in practice, be reliably monetized in time of stress. This objective is reflected in specific recommendations below.

SYSTEMIC RISK ASSESSMENT

A. Vulnerabilities and Risks

11. Ecuador's exposure to macrofinancial risks and global spillovers is shaped by its fully dollarized economy and its position as an oil exporter. The corporate and household sectors do not appear overly indebted, and mortgage lending is modest (Figure 4). However, banks and cooperatives have not fully recovered from the impact of the pandemic and now face new challenges stemming from tightening financial conditions and ongoing political uncertainty. Direct exposures to sovereign risk are limited,[2] but indirect effects and the presence of public banks and BIESS also entail channels of contagion between the financial and the public sectors. Market risks are immaterial, including interest rate risk in banking book and small trading book. Against this background, an abrupt slowdown in China and the United States accompanied by falling oil prices could substantially affect the financial sector. Political and social discontent is an additional source of systemic risk that could affect private investment and economic activity and possibly lead to sub-optimal financial sector policies.

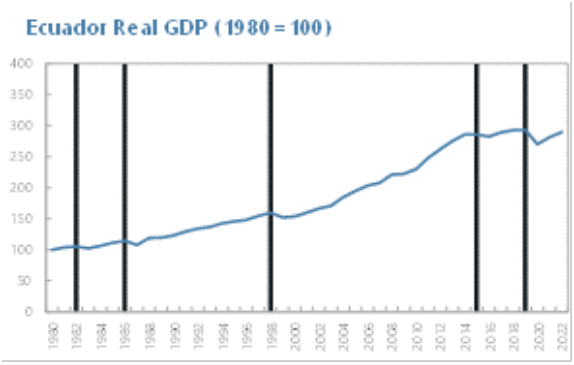
12. The FSAP assessed the resilience of banks, credit cooperatives and non-financial corporates; the financial system is overall resilient to adverse macro-financial shocks. The analysis comprised all 24 banks, the large credit cooperatives and more than 86,000 registered non-financial companies.

13. The analysis is based on a baseline and an adverse scenario spanning three years (2023–25). Both scenarios are challenging, as their starting point includes the effects of the pandemic and the social turmoil in mid-2022. The baseline scenario follows the April 2023 WEO projections (Table 3). It assumes a weakening external environment, with oil prices easing gradually and global demand slowing down. Financial conditions are affected by the tightening of monetary policy in industrial countries and appreciation of the US dollar. The adverse scenario assumes sharper than expected slowdowns in China and the United States and increases in inflation and policy rates in industrial countries (Figures 5 and 6).

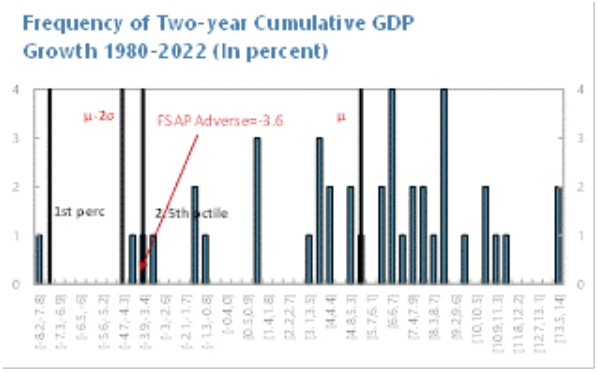
[2] Investment in public securities represents about 10 percent of bank assets and 85 percent of their capital. The public and medium-sized banks tend to be more exposed to sovereign risk.

Figure 5. Ecuador: Adverse Scenario Benchmark

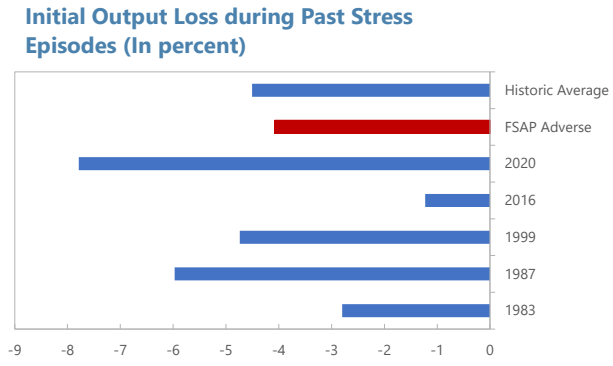
Between 1980 and 2022 Ecuador had 5 episodes of economic recession.



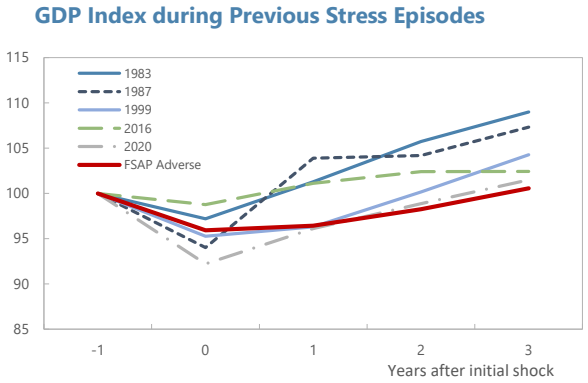
The two-year cumulative fall in economic activity under the adverse scenario is at about the fifth percentile of the historic distribution for Ecuador.



The initial output loss under the adverse scenario stands close to the average of past adverse episodes.



But the subsequent rebound in economic activity was assumed to be slower than in the past, reflecting the synchronized global shock and lack of external demand.



Source: IMF staff calculations.

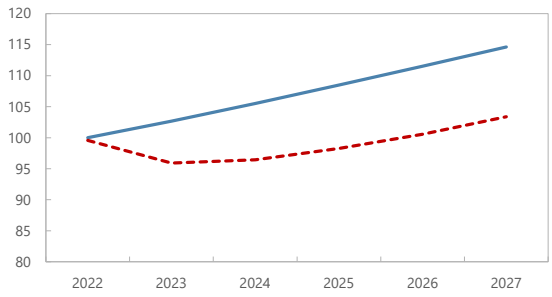
Figure 6. Ecuador: Baseline and Stressed Scenarios

(In percent, unless otherwise indicated)

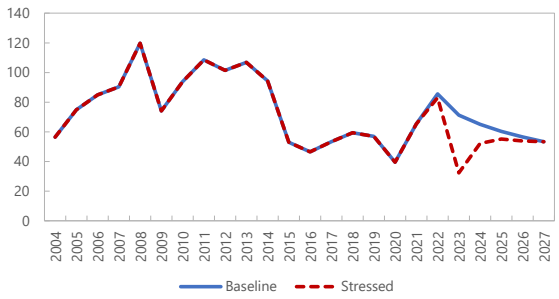
In the adverse scenario Ecuador experiences two consecutive years of recession and a slow recovery.

Dropping oil prices, weakening global demand, and tightening external financing conditions…

Real GDP 2022=100



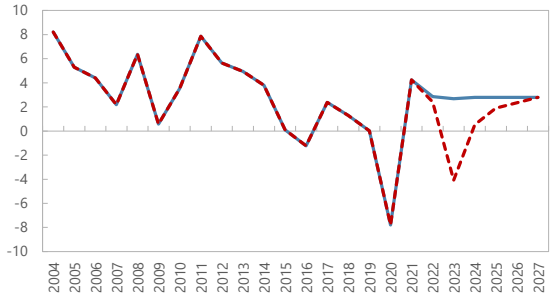
Real Oil Prices, in 2020 USD per Barrel



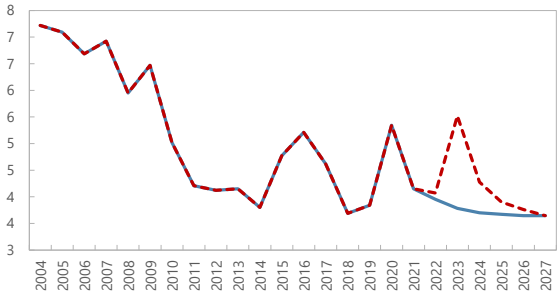
…reduce economic activity, …

… and lead to higher unemployment,…

GDP Growth



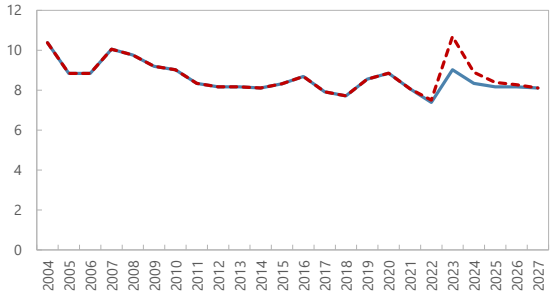
Unemployment Rate



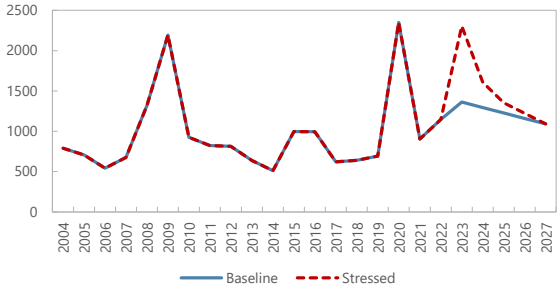
…,elevated lending rates,…

and a spike in EMBI spreads.

Average Lending Rate



Ecuador EMBI Spreads



Source: IMF staff calculations.

B. Bank Solvency Stress Tests

14. The solvency analysis integrated credit, sovereign, and interest rate risks. The core methodology entailed a top-down stress test of individual bank solvency, integrated with a corporate stress test of the 100 largest borrowers.[3] The cut-off date was December 2022.

15. The solvency ratios of a relatively large number of banks dropped below the minimum capital adequacy ratios (CAR), but the aggregated capital shortfalls were small. The capital ratios of five small banks, which account for two percent of system assets, dropped below 9 percent even under the baseline scenario. These institutions displayed undiversified credit portfolios, with exposure to consumer and small and middle enterprise (SMEs) loans and to agricultural sector micro loans. Under the adverse scenario, nine banks with 11 percent of system assets end up with CAR ratios below the regulatory minimum, but with an aggregate capital shortfall of only 0.2 percent of GDP (Figure 7).

16. At the aggregate level, the banking system appears profitable enough to absorb the losses stemming from the adverse scenario. Aggregate bank profits contribute to material internal capital generation even under the adverse scenario. Credit losses and distributed dividends[4] are the main drag on solvency. Large interest rate and sovereign risk shocks in the adverse scenario had only moderate solvency impacts due to short duration assets and already-high spreads, assuming that interest rate caps are adjusted when needed, in line with historic behavior.

C. Cooperatives Stress Tests

17. The solvency stress tests for the cooperative sector followed the same scenario-based approach applied to the banking sector. Expected losses were estimated as the flow of provisions under the baseline and adverse scenarios (Figure 8). The analyses included the larger cooperatives in segments 1 and 2 individually and segment 3 in aggregate.

18. The results suggest that a substantial number of mostly small cooperatives could face solvency challenges. The materialization of the adverse scenario would increase expected losses, particularly for the microcredit portfolio, and reduce profitability and capital adequacy. By 2025, the capital adequacy ratio of 35 cooperatives, representing about 6 percent of system assets could be below the 9 percent minimum requirement. The aggregate capital shortfall, however, is relatively small (0.2 percent of GDP). Several cooperatives could also face solvency challenges under the baseline scenario.

[3] See Appendix I: Stress Testing Matrix for further details.

[4] Healthy banks with a CAR above 12 percent are assumed to distribute two-thirds of their profits.

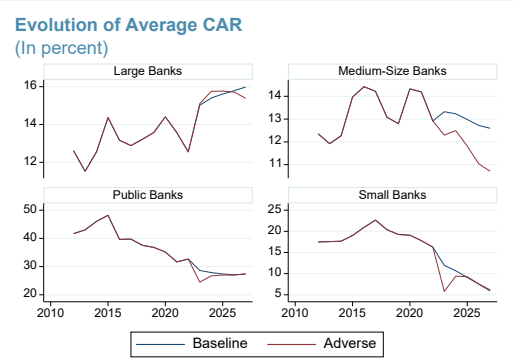
Figure 7. Ecuador: Selected Results of Bank Solvency Analysis

A relatively large number of banks fall below the minimum CAR, but aggregate capital shortfalls are small.

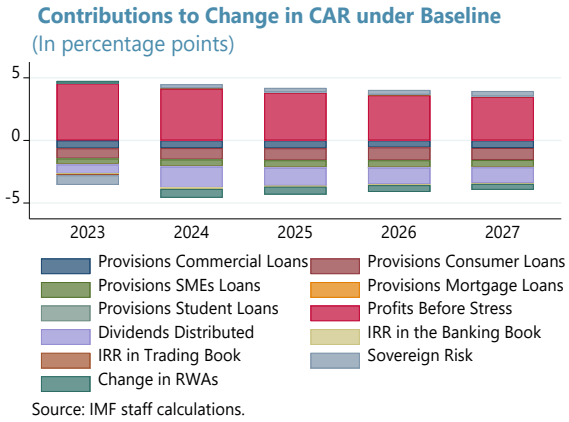
Ecuador, Selected Results of Bank Stress Testing

	2023	2024	2025
Number of Banks failing on CAR			
Baseline	3	4	5
Adverse	8	9	9
Failing Bank Assets to System Assets, in percent			
Baseline	0.5	0.8	2.0
Adverse	8.0	11.4	11.4
CAR Shortfall, in percent of GDP			
Baseline	0.0	0.0	0.1
Adverse	0.1	0.1	0.2

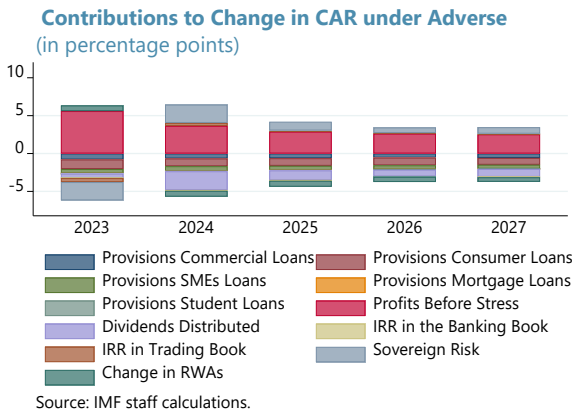
Source: IMF staff calculations.



Aggregate bank profits contribute to material internal capital generation even under the adverse scenario, while the larger credit losses originate from consumer, corporate and SME loans. Interest rate risk is small, reflecting small duration gap and repricing gaps between assets and liabilities

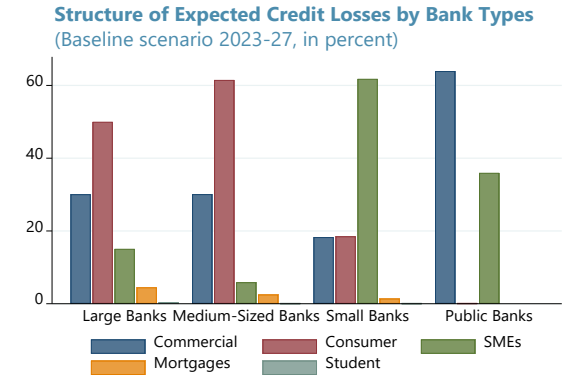


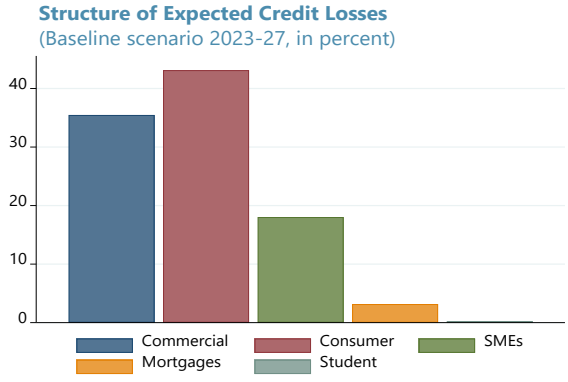
Source: IMF staff calculations.



Source: IMF staff calculations.

The profiles of credit losses are dissimilar across bank types. The large and medium-sized banks appeared more exposed to losses stemming from consumer and commercial lending. Small banks are more exposed to losses from SMEs, while public banks are more exposed to commercial and SME lending, reflecting their specialization.



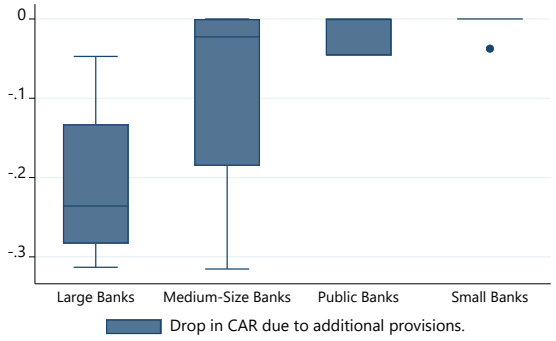


Source: IMF staff calculations

Figure 7. Ecuador: Selected Results of Bank Solvency Analysis (concluded)

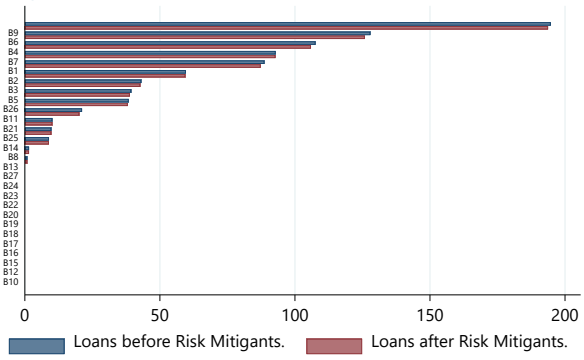
The actual loan-loss provisions of each of the largest 100 corporate borrowers were found broadly appropriate.

Impact of Provisions on 100 Largest Borrowers
(In percentage points, 2022)



Concentration risk in credit portfolios is not prevalent: most individual bank exposures to the largest 100 borrowers were lower than 50 percent of the capital.

Loans to 100 Largest Borrowers to Capital
(In percent, 2022)



Bank investment portfolios are moderate in size, mostly domestic, marked-to-market and not provisioned.

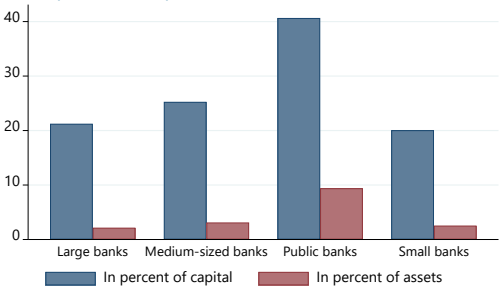
Ecuador, Bank Securities Portfolios, June 2022

	Rest-of-the-World	Ecuador	Total
Book value (Mil. USD)	1,940	5,865	7,805
Existing provisions (Mil. USD)	17	132	148
Percent of Capital	23.9	72.3	96.2
Percent of Assets	3.1	9.5	12.7

Source: Superintendence of Banks and IMF staff calculations.

Overall, the exposure of banks to government securities represents 3.7 percent of assets.

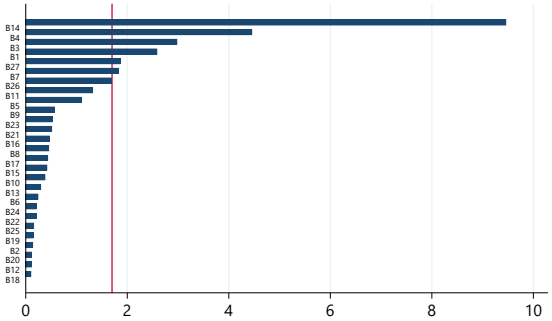
Investments in Ecuadorian Public Securities, 2022
(In percent of capital and assets)



Source: Superintendency of Banks and IMF staff calculations.

The maturity of government securities is relatively short. Thus, the impact of shocks to sovereign spreads on bank solvency is immaterial.

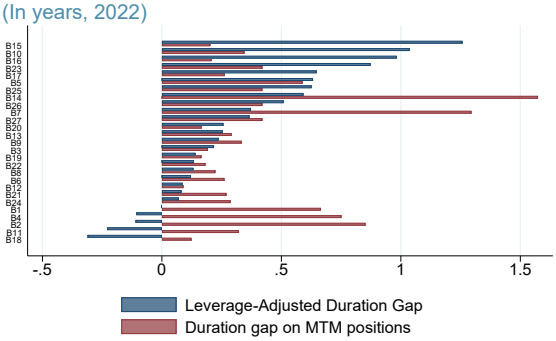
Bank Holdings of Ecuadorian Public Securities
(Average maturity in years, 2022)



Source: Superintendence of Banks of Ecuador and IMF staff calculations.

Interest rate risk is low due to the combination of a relatively high interest rate environment, and small duration and repricing gaps.

Bank Duration Gaps
(In years, 2022)



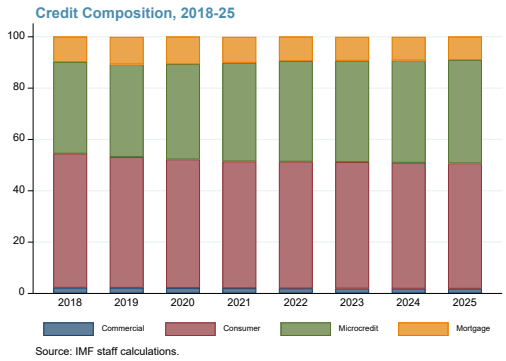
Source: Superintendence of Banks of Ecuador and IMF staff calculations.

Source: IMF staff calculations.

Figure 8. Cooperative Credit Solvency Analysis

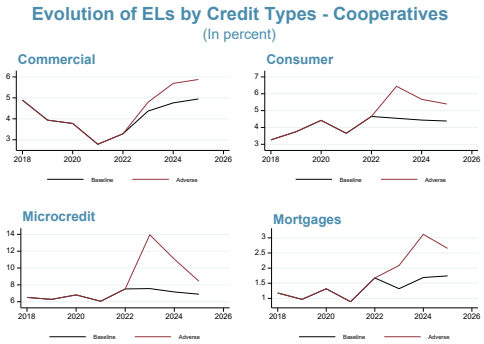
Stress tests reveal the split between strong institutions and those at risk from both weak asset quality and poor profitability

Consumer and SME (including microcredit) loans dominate coop loan portfolios.

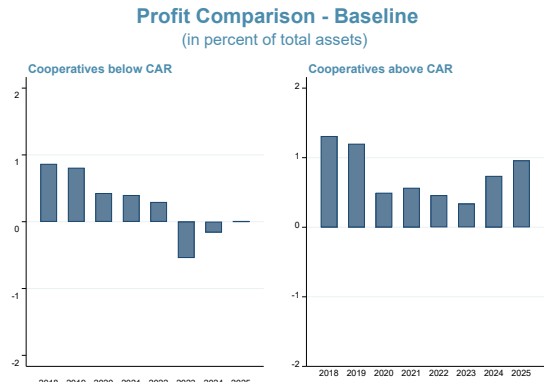


Source: IMF staff calculations.

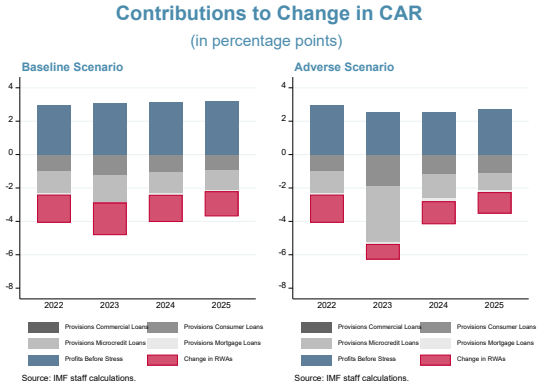
SME loans have the highest expected loss ratio.



Profitability for well-capitalized cooperatives returns to pre-pandemic levels in 2024.



The main contributor to the change in aggregate CAR is increased provision levels in 2023.



Source: IMF staff calculations.

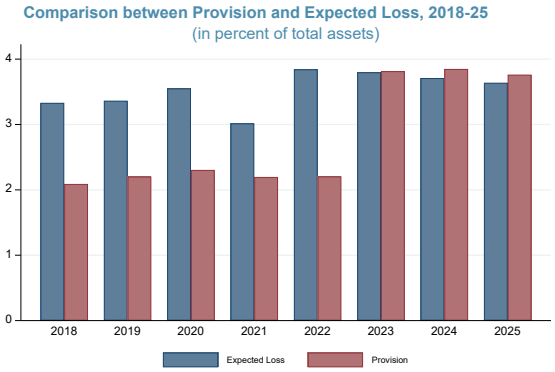
Several cooperatives may face challenges meeting the 9 percent capital ratio, but capital shortfalls are relatively low.

Ecuador, Selected Results of Cooperatives Stress Testing

	2023	2024	2025
Number of Cooperatives below 9 percent CAR			
Baseline	6	11	19
(of which, the 10 largest Cooperatives)	-	1	1
Adverse	20	31	35
(of which, the 10 largest Cooperatives)	3	4	4
Assets of cooperatives with CAR below 9 percent (percent of assets)			
Baseline	4.3	11.8	17.7
Adverse	25.6	36.9	41.3
CAR Shortfall, in percent of GDP			
Baseline	0.0	0.0	0.1
Adverse	0.1	0.2	0.2

Source: IMF staff calculations.

The stress test assumes cooperatives close the gap between provisions and expected losses.



Source: IMF staff calculations.

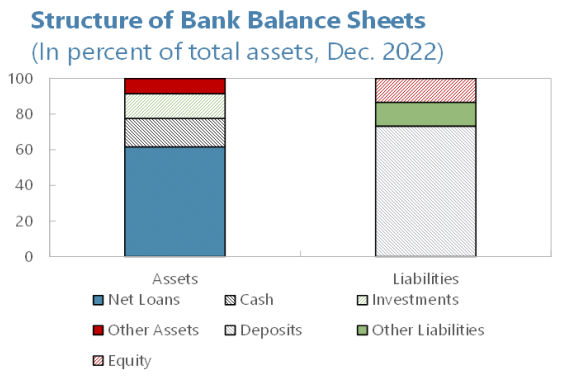
Sources: Superintendencia de Economia Popular y Solidaria and IMF staff calculations.

D. Liquidity Stress Testing

19. The assessment of liquidity risk was constrained by data availability. Liquidity risk at the bank level was therefore assessed using the results of a recent pilot project on the Liquidity Coverage Ratio (LCR) which covers the six largest banks, jointly accounting for about 60 percent of system assets. Parallel analysis was carried out using data from supervisory liquidity gap templates. Considering the shallow domestic secondary markets and the lack of a Lender of Last Resort (LOLR), the analysis differentiated domestic and foreign High Quality Liquid Assets (HQLA), as the latter are more likely to prove truly liquid.

20. Results suggest that banks do not hold enough liquid assets. The core assessment comprised three scenarios that imposed a drawdown of bank liabilities (which are mostly deposits) following the Basel LCR weights. The least severe scenario considered no haircuts on domestic securities and no use of liquidity fund resources. Under this exercise, three of the six banks accounting for about 25 percent of system assets fall below the reference LCR (Figure 10). A more realistic exercise assumed that domestic securities could not be monetized.[5] Under these assumptions, five banks accounting for 37 percent of system assets drop below the reference LCR.

Figure 9. Ecuador: Structure of Bank Balance Sheets



Sources: SB, and IMF Staff calculations

21. Systemic liquidity is the main risk to financial stability given the lack of a domestic currency and insufficient foreign assets. A systemic liquidity analysis compared estimated bank liquidity shortages against their claims on the liquidity fund. Half of the sampled banks maintain insufficient claims on the liquidity fund to restore a 100 percent LCR, with one medium-size bank displaying a liquidity deficit 3.7 times larger than its claims. However, two systemically important banks were able to cover their liquidity deficits with resources from the liquidity fund. Extrapolation of the results for the pilot banks suggests a system-wide liquidity deficit of about US$2.9 billion.[6]

[5] The exercise assumed outflows for each balance sheet item in line with the Basel LCR standard.

[6] This estimate was obtained by extrapolating the liquidity deficit of the banks that participated in the LCR pilot project, excluding one outlier.

E. Nonfinancial Corporates

22. The corporate stress test indicates that corporate debt-at-risk is not an imminent threat to financial stability. A corporate stress test with the FSAP scenarios translated into sectoral-level impacts was carried out covering the entire population of registered firms with available financial statements. Results show that aggregated debt-at-risk, measured by the debt of companies with an interest coverage ratio (ICR) below 100 percent, is about 6 percent of GDP. Overall, the migration of companies to lower ICRs appears moderate, which is likely due to their relatively low indebtedness (Figure 11).

Figure 10. Ecuador: Selected Results of Liquidity Stress Tests

Banks' liquid assets are composed mostly by reserves at the BCE and domestic securities and deposits.

Composition of Bank Liquid Assets

(In mil. USD)

	Abroad	Ecuador	Total
Reserves and Deposits at BCE	0	6,015	6,015
Non-Financial Corporations	15	485	500
Sovereign Securities	0	1,649	1,649
IFIs	1,579	0	1,579
Private Banks	18	1,693	1,711
Public Banks	0	713	713
Credit Cooperatives	0	96	96
Investment Funds and Escrow	0	534	534
Total	1,611	11,186	12,797

Currently, most banks would not comply with the strict application of the LCR standard.

Results of LCR-Based Liquidity Stress Test

	LCR			Outflows, in percent of:		
	Baseline	Stress 1	Stress 2	Deposits	Liabilities	Size 1/
B1	81.7	79.3	68.7	31.7	26.9	10.8
B2	75.9	69.4	59.6	26.0	23.8	7.0
B3	159.8	106.2	88.3	13.4	8.6	1.0
B4	117.2	123.8	103.1	18.7	16.4	23.7
B5	141.5	89.6	68.0	20.0	16.6	10.5
B6	54.1	40.6	33.5	44.1	38.3	7.5

1/ Percent of system assets.

Baseline: 100 percent weight on domestic securities and 0 percent weight on bank claims on the Liquidity Fund.

Stress 1: 0 weight applied to domestic securities and 50 percent weight to bank claims on the Liquidity Fund.

Stress 2: 0 weight applied to domestic securities and 0 percent weight to bank claims on the Liquidity Fund.

Claims on the Liquidity Fund are insufficient for some banks to address the liquidity shortfall.

Liquidity Shortfalls under Stress Scenario

(In mil. USD)

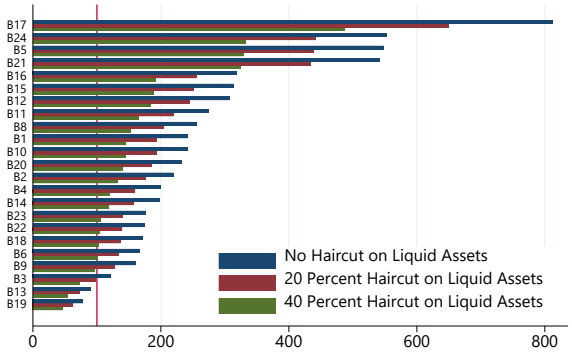
	Net Outflows	HQLA	Liquidity Needs	Claims on Liquidity Fund	Liquidity Deficit
B1	1,414	971	442	300	142
B2	743	443	300	146	154
B3	38	34	5	14	0
B4	1,612	1,661	0	668	0
B5	664	451	213	287	0
B6	1,440	483	957	202	755
Total	5,911	4,044	1,916	1,617	1,051

Assumptions: 0 weight applied to domestic securities and 0 percent weight to bank claims on the Liquidity Fund.

The main results of the exercise seem to hold for the broad banking sector.

LCR Proxy

(In percent)



Source: IMF staff calculations.

Figure 11. Ecuador: Selected Results of the Nonfinancial Corporate Stress Test

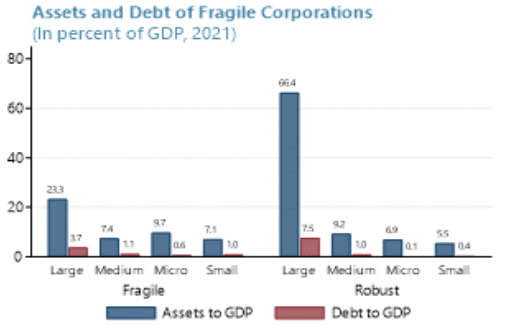
The corporate sector is relatively small, fragmented and, in aggregate, not overly indebted.

Coverage of Corporates

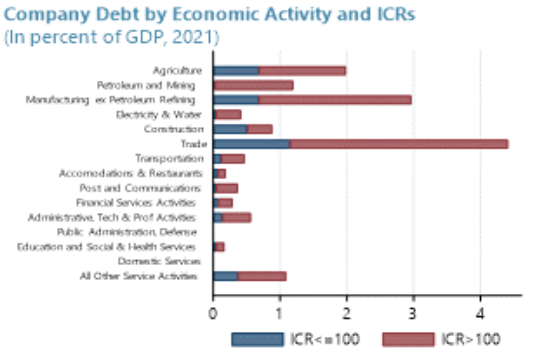
	Number of Companies	Assets to GDP	Debt to GDP
Large	3,215	89.7	11.2
Medium	7,041	16.6	2.1
Small	21,106	12.5	1.3
Micro	55,027	16.6	0.8
Total	86,389	135.3	15.4

Source: Superintendencia de Companias and IMF staff calculations.

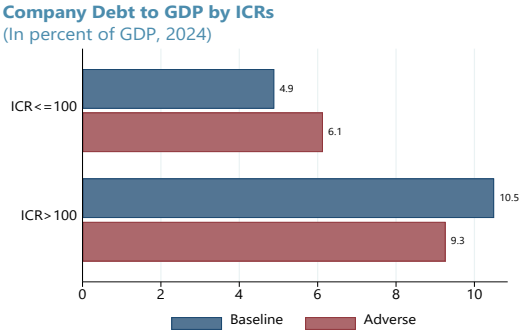
About two-thirds of firms, representing one-third of total assets qualified as weak under the FSAP analysis.



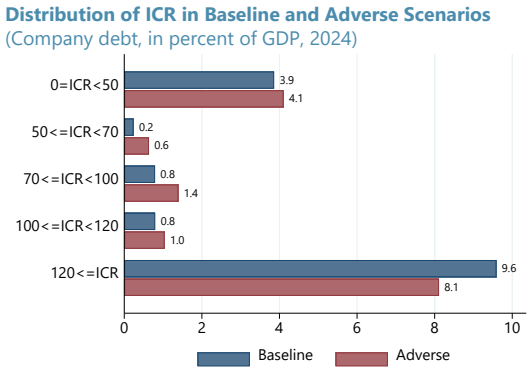
The economic sectors with more material indebtedness are trade, manufacturing and oil, and agriculture.



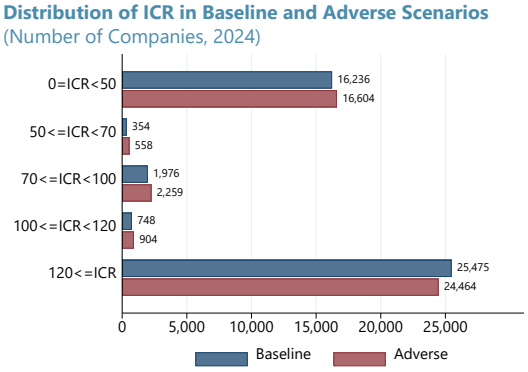
Firms with interest coverage ratio (ICR) below 100 percent in the adverse scenario are limited...



...as the migration of the volume of debt.....



... and companies to lower ICRs is relatively low, reflecting their relative low indebtedness.

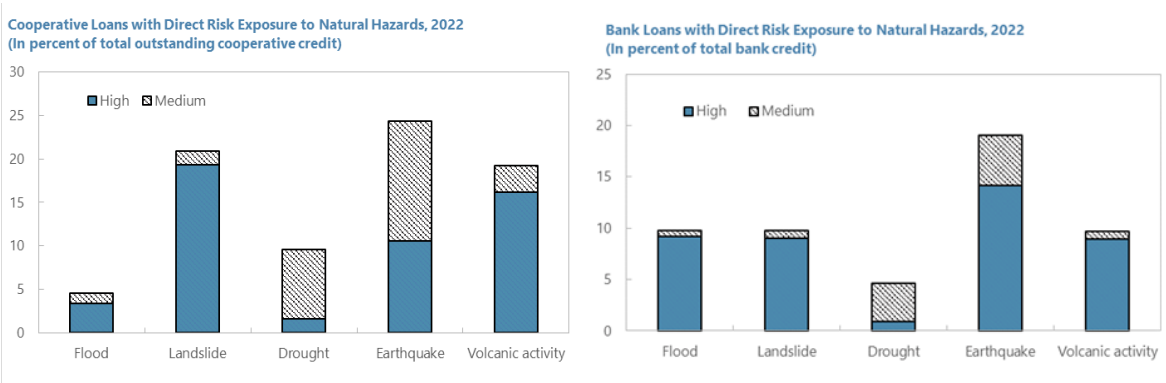


Source: IMF staff calculations.

F. Climate-Related Risks

23. Ecuador's high exposure to natural hazards poses physical risks for banks and credit cooperatives. Ecuador has the 13th largest exposure in the world to natural hazards according to the INFORM Risk index.[7] Up to 20 percent of bank loans and 25 percent of cooperative loans are in parts of the country vulnerable to floods, landslides, droughts, and volcanic and seismic risks (see Figure 12). Around 23 percent of system-wide bank loans in Ecuador are also extended to borrowers in sectors that are considered as 'transition sensitive' (primarily agriculture).

Figure 12. Ecuador: Financial Sector Exposure to Climate Physical and Transition Risk



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

FINANCIAL SECTOR OVERSIGHT

A. Cross-cutting Issues

24. Coordination and information-sharing between the large number of institutions playing a role on financial sector issues is lacking (Table 2). Often, regulatory proposals are developed in isolation, financial stability analysis only considers specific segments of the financial sector, and the information is shared too late to effectively prepare for the failure of weak institutions.

25. Effective micro and macroprudential policies and tools can be built under different oversight architectures. Often, maintaining the stability of existing institutions and focusing on

[7] INFORM is a multi-stakeholder forum for developing shared, quantitative analysis relevant to humanitarian crises and disasters. INFORM includes organizations from across the multilateral system, including the humanitarian and development sector, donors, and technical partners.

addressing their weaknesses, tend to generate better and faster results than unifying or dismembering agencies, as this process tends to distract from the underlying shortcomings.

26. The superintendencies should play a large and active role in the regulatory process. The Código Organico Monetario y Financiero (COMyF) grants comprehensive powers to the Junta of Financial Policy and Regulation (JPRF) to issue regulations. The superintendencies, however, have a direct knowledge of the sectors that they supervise and stronger analytical capacity. The JPRF should solely play the key role of coordinator and ultimate authority on regulatory issues, particularly to harmonize cross-sector regulations and implement timely macroprudential actions. The superintendencies should have an active part in the regulatory process, including by proposing regulations, conducting joint impact analysis, and opining on all regulatory matters applicable to the entities that they supervise.

Table 2. Ecuador: Institutional Framework for Financial Sector Oversight

Institution	Mandate / Role in the Financial Sector Policies
Ministry of Economy and Finance (MEF)	• Responsible for legal framework. • Any use of public funds. • Governance of public banks.
Junta of Financial and Regulatory Policy (JPRF)	• Prudential rulemaking. • Setting of interest rate ceilings. • Financial stability report coordination.
Junta of Monetary Policy and Regulation (JPRM)	• Stability of the monetary and payment systems, and coherence of dollarization. • Setting of reserve and liquidity requirements. • Oversight of the BCE.
Central Bank of Ecuador (BCE)	• Implementation of JPRM policy. • Oversight of payment systems. • Supports JPRF stability analysis.
Superintendency of Banks (SB)	• Supervision of banks.
Superintendency of Cooperatives (SEPS)	• Supervision of cooperative deposit-takers (and non-financial cooperatives).
Superintendency of Companies, Securities, and Insurance (SCVS)	• Supervision of financial markets, securities issuance, and insurers.
Corporation of Deposit Insurance (COSEDE)	• Deposit insurance payout; asset & liability transfers in liquidation. • Management of the Liquidity Fund.

B. Macroprudential Framework

27. Authorities are committed to strengthen the macroprudential framework; it is key that current efforts are expanded as the framework has several shortfalls. Authorities have been discussing a common definition of financial stability, planning to publish a financial stability report, and considering system-wide data collection. These initiatives need to be completed and expanded. First, the current framework is complex and has an unclear distribution of objectives, functions, and powers among authorities. Weak information sharing and coordination arrangements add obstacles

to policy making. Second, the authorities lack a systematic process to monitor system-wide financial stability risks. Third, although the legal framework foresees the use of some macroprudential tools, such as additional capital buffers reflecting the phase of the credit cycle and the systemic importance of banks, none have been implemented.

28. To enhance the macroprudential framework the authorities should:

- **Clarify the macroprudential objectives, functions, and powers of each agency.** The JPRF should be the overall coordinator of macroprudential policy, and all other agencies should have clear roles and responsibilities in contributing to this goal.

- **Strengthen coordination arrangements and practices between agencies.** The authorities also need to urgently establish a systematic process to monitor and evaluate system-wide risks. Authorities could consider the establishment of a Financial Stability Committee in charge of the analysis of systemic risks, the development and monitoring of core indicators, and the preparation of policy proposals to manage systemic risks.

- **Improve data collection, reinforce data sharing among agencies, and enhance analytical capacity.** Improvement is needed in areas such as systematic reporting of indices relevant to macroprudential policy, like housing market statistics, indebtedness, and system-wide indicators.

- **Implement the Basel III buffers (conservation, countercyclical and for domestic systemically important banks), and borrower-based measures.** The implementation of these measures should follow international standards and Basel guidelines.

- **With appropriate phasing, remove the requirement to hold 60 percent of liquid assets in domestic assets.** It is especially important to ensure liquid assets can be sold in deep markets and strengthen system-wide liquidity. The process should be gradual and consider macroeconomic conditions, to avoid triggering an unintended shortfall of domestic financing sources for the public sector.

C. Banking Regulation and Supervision

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

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

- **Safety and soundness are not the primary goal of the SB which, in practice, results in the prioritization of SB's broader responsibilities over prudential goals.** The SB has a very broad mandate (including, *inter alia*, consumer protection, enforcement of interest rate caps, social security oversight, bank resolution etc.). These other duties often disrupt prudential supervisory planning and consume a significant amount of time and resources. The law should recognize

safety and soundness as the primary objective and the internal structure should segregate units dedicated to prudential and non-prudential duties.

- **The legal independence of the SB has many practical constraints that have generated substantial institutional instability.** The appointment procedure for Superintendents is prone to disputes and the removal procedure is excessively discretional. These characteristics have led to high instability at SB's senior positions that impair the continuity of work and deviate the attention of senior managers to non-prudential topics. The administrative autonomy of the SB is also undermined by the significant number of requests from other State authorities and the need for consent from the Ministries of Finance and Labor for budget decisions and changes in internal organization. Laws and rules should be reformed to ensure that the SB is able to self-organize and to administer its staff and budget efficiently, stably, and independently. The rules for appointment of the Superintendent need to be strengthened to restrain discretion on removals.
- **Lack of a career plan and a sound training program has significantly hindered the acquisition and retention of talent**. The turnover of staff and management of the SB is very high, hindering the accumulation of supervisory knowledge and the implementation of projects.

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

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

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

- **Consolidated supervision** should be enhanced by a more comprehensive supervisory perimeter and regular group-wide examinations.
- **Capital and liquidity regulation** should gradually align to the Basel Framework, particularly in relation to the definition of capital and Pillar 2 requirements. Banks should also be required to adopt a forward-looking approach to capital and liquidity management.
- **Corporate governance** requirements should be strengthened to properly determine the responsibilities and functions of senior management; supervisory procedures should be enhanced in order to better assess the effectiveness of the board's risk oversight.
- **Corporate exposures** classification and provisioning needs further supervisory attention. While non-corporate exposures are classified based on past dues in a conservative way, corporate exposures are classified based on expert models and currently result in less provisioning than IFRS 9, as these models don't properly account for macroeconomic conditions and shocks.
- **Accounting criteria** should be aligned to IFRS. The qualification process applied to external auditors also needs to be strengthened.
- **Supervisory response to climate and environmental risks** is at an early stage and should be strengthened.

D. Cooperative Regulation and Supervision

34. Authorities are making an ongoing effort to converge prudential regulatory requirements of large cooperatives with those applied to banks. Prudential regulations have in the past been generally more lenient for cooperatives than for banks, leading to potential regulatory arbitrage. The authorities have been working to level the playing field. Capital, loan classification and provisions, and liquidity requirements of cooperatives have been harmonized with banks. There remain differences in reserve requirements and contributions to the liquidity fund, but convergence is underway, and expected to finish in 2025 and 2027, respectively. The possibility for cooperatives to retain up to 3 percent of the amount of a loan as capital also constitute a meaningful competitive advantage to cooperatives when the interest ceilings are binding.

35. SEPS's legal powers and autonomy have shortcomings which impair sound supervision. The SEPS cannot remove cooperatives' Council members for technical breaches and the existing fit and proper requirements are lax. Corrective actions are limited to cooperatives under intensive supervision programs, which limits an early supervisory response. SEPS has similar limitations on its administrative autonomy as the SB.

36. The supervisory approach has weaknesses in scope, risk profile assessments and adoption of early corrective actions. The supervision plan is not based on a comprehensive supervisory cycle and overemphasizes offsite activities. In result, the number of onsite assessments is relatively small. The risk classification methodology is based on quantitative indicators and

thresholds that are not risk-sensitive enough; and the scores' aggregation method underestimates the importance of qualitative indicators. These limitations affect the timely identification of higher-risk cooperatives and the adoption of early corrective actions.

37. The supervision of the largest cooperatives needs substantial improvements. The organizational structure and the practice of assessing the same issues in both offsite and onsite supervision are not conducive to a comprehensive view of their risk profile. The supervisory approach is not forward-looking, and supervisors do not challenge cooperatives' strategies, policies, and methodologies enough. Core topics such as business model viability and ability to assess debtor payment capacity are not subject to a comprehensive examination. Considering that the operations and business models of the largest credit cooperatives are closer to banks than the other cooperatives, authorities could consider transferring the supervision of the largest cooperatives to the SB. The transfer could enhance the efficiency and effectiveness of supervision by grouping institutions that require a similar supervisory approach under the same superintendency.

38. The cooperative supervisory and regulatory framework would also benefit from closing gaps in several areas, including:

- **Corporate governance and risk management:** Supervisors need to set expectations, proportional to the size and risks faced by the cooperative, that foster a comprehensive risk culture and sound risk management practices.
- **Credit risk:** The regulation of does not establish minimum requirements for evaluation, approval, and monitoring for each type of loan. SEPS does not have access to consolidated clients' debt data, which limits its ability to measure and supervise over-indebtedness risk.
- **Classification and provisions:** Although in January 2023 loan provision requirements have been raised, there are concerns about the timely disclosure of credit risk in the cooperatives' balance sheets, due to financial relief measures, weaknesses in internal and external auditors and risk rating agencies, and limited scope and depth of supervisory assessments to detect evergreening practices.
- **Capital and liquidity:** As recommended for banks, regulation and supervision should gradually align to the Basel Framework, with proportional simplification of the requirements for small cooperatives. Eventual adjustments, however, should not reduce the stringency of the requirements.
- **Supervisors' skills:** Overcoming the gaps described above necessarily requires a strengthening of the supervisor's skills, through a comprehensive and specialized training program with the necessary resources for its implementation.

E. Financial Integrity (AML/CFT)

39. Ecuador has started the reform of its AML/CFT framework based on the findings of the latest Mutual Evaluation Report; political commitment is key for further progress. The enactment of the New Organic AML/CFT Law by the forthcoming National Assembly is critical. Although the National AML/CFT Strategy was approved, its publication and the engagement with the private sector are still pending. Furthermore, an updated National Risk Assessment is underway,

including additional modules on tax crimes, environmental crimes, assessment of legal entities, state-owned entities, nonprofit organizations, and crypto assets.

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

FINANCIAL CRISIS MANAGEMENT AND RESOLUTION

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

42. The FSAP identified several priority areas for strengthening the resolution framework.

- **The supervision and resolution functions should be separated**, either by establishing an independent department within the SB/SEPS or by shifting responsibility for resolution to COSEDE.
- **Existing resolution tools should be strengthened.** The superintendents have three instruments: mergers, the "exclusion and transfer of assets and liabilities" (ETAP, a P&A-like power), and liquidation. The ETAP should be converted to a more traditional P&A power, whereby the resolution authority packages assets and deposits for an acquiring institution.
- **The preparation time for resolution should be lengthened and needed data provided in advance of failure.** Currently, COSEDE has no access to data before resolution is triggered and, after triggering, the resolution authorities have only 15 days, by law, to determine the resolution plan, conduct the least cost analysis, appoint an Administrator, and begin resolution.

43. Over the medium term, an overhaul of the legal framework for resolution is warranted. The authorities should consider the introduction of a comprehensive financial institution resolution law. That law would establish a resolution agent, separate from the supervisory function. It should establish additional resolution tools and address any remaininglimitations of the current tools. In particular, the law should introduce bridge-bank and bail-in powers**.** A tighter timeline for the implementation of resolution actions should be established. Legal certainty of resolution actions needs to be enhanced given that judicial review of supervisory actions is very broad and has led to several cases in which closed institutions have been ordered to be reopened with no clarity about

the status of their assets, liabilities, or operations. If this occurred for a major financial institution the risk of financial instability would be very high.

44. The deposit insurer has some strong practices but also weaknesses that need to be addressed, especially if it were given a greater role in resolution:

- **The governance of COSEDE should be strengthened** to include independent members appointed to the Board.
- **Payout time should be shortened.** Payout is limited by a lack of data. COSEDE pays out within 20 days of receiving depositor data from the liquidator. However, the liquidator can take up to 60 days to prepare such data, which should be significantly shortened.
- **COSEDE staffing should be improved.** While it has 56 employees, only six are permanent staff, with the remaining seconded on a rotating basis from other institutions. If resolution responsibilities were shifted to COSEDE it would need substantially more resources, staffing and expertise.
- **Funding of COSEDE should be strengthened**, **despite the substantial ex-ante fund (17 percent of covered bank deposits).** Options include giving COSEDE authority to increase premiums on banks and establishing a back-up liquidity facility.
- **Safeguards should be set limiting the use of its resources** to the amount it would have paid out to insured depositors in a liquidation.
- **Introduction of clear legal foundation for depositor preference.**

45. Given dollarization, Ecuador operates an industry-funded Liquidity Fund in the absence of a standard lender-of-last-resort regime. The BCE does not provide an emergency liquidity facility and may face legal impediments to taking government securities as collateral. The Liquidity Fund is a government-mandated industry support mechanism where institutions deposit their funds and can borrow them back. However, access is limited to the amount of bank equity and is over-collateralized, and the practices for posting collateral are untested. Accordingly, the liquidity fund would only have a limited role during widespread financial distress or a significant deposit run. Consideration should be given to the development of a more flexible lender-of-last resort facility, with possible reforms to governance and information-sharing, ease of collateral posting, size of the fund, relations with the BCE, and terms of lending, although its scope will remain limited by dollarization.

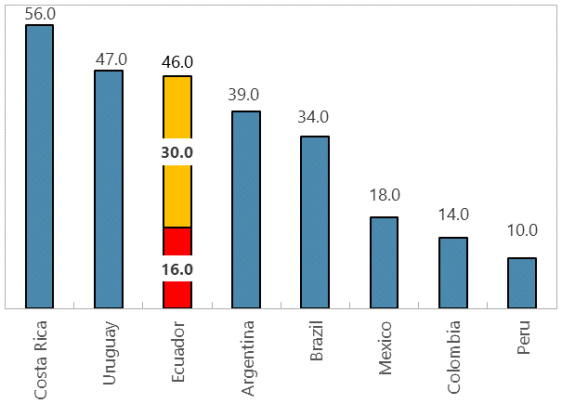
FINANCIAL SECTOR DEVELOPMENT

A. Role of the State

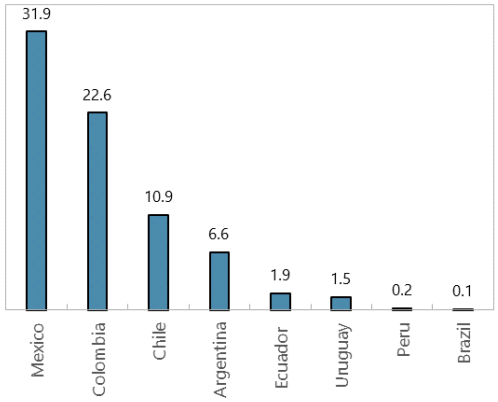
46. The State plays an important role in the provision of financial services in Ecuador through SOFIs. Six SOFIs in Ecuador hold 36 percent of total financial sector assets, among the largest in Latin America, operating in asset management, and commercial and development banking**.** SOFIs are key actors in mortgage and microcredits segments (Figure 13).

Figure 13. Ecuador: State-Owned Financial Institutions in Latin America

State-Owned Bank Assets, 2022
(In percent of total assets)



Credit to SMEs Covered by Public Guarantees, 2019 (In percent of total credit to SMEs)



Sources: National Supervisory Agencies; *Challenges of PCG Schemes in Latin America during the Pandemic* (2022).
Note: **In orange: BIESS**; **In red: 5 SOFIs**.

47. SOFIs in Ecuador have operated within a legal, regulatory, governance and organizational frameworks that appear far from international good practices. An ownership policy should be developed including criteria to justify ownership, a centralized unit to exercise ownership/monitoring functions, and strong governance practices. Many SOFIs have deficient credit risk management processes and IT systems that have been long unaddressed. Authorities should focus on restructuring problem SOFIs rather than merging them. The CFN-Banecuador merger should be paused until a viability assessment is conducted. The framework for BIESS could be enhanced to make it more alike to a fund administrator, have it report to credit bureaus, and conduct an AQR of its mortgage and trust investments.

48. Public credit support programs should be redesigned to enhance effectiveness. Public credit programs should be part of broader interventions including business advisory services. Programs should focus on viable but underserved new borrowers and include incentives for loan repayment. Credit subsidies should cover the cost of credit to ensure participation of private credit providers. Expectations of debt forgiveness should be eliminated, and the system of interest rate caps should migrate to a usury rate.

B. Capital Markets Development

49. Government and corporate debt securities are sold through private placements and rarely transacted in the secondary market. The government fixes the interest rates of government securities usually below market rates. Events of default and fraud have damaged the reputation of a rather thin corporate debt market. Issuance requires cumbersome approval processes that do not offer adequate protection to the investor. The infrastructure for transacting government and corporate debt faces operational and reputational risk and requires significant upgrades to comply with international sound practice. Green finance markets are also at a nascent stage. A more active

bond market would not only provide a robust financing alternative to the government but will also mitigate the vulnerability of the financial system to liquidity shocks.

50. Capital markets in Ecuador have not developed because the critical preconditions for a local bond market to emerge are still lacking. Recurring external debt defaults, structural macroeconomic imbalances, and the absence of a long-term savings industry suggest that market development should be approached as a gradual, long-term endeavor. However, phased actions to improve the functioning of the government bond market should begin sooner rather than later, starting by replacing private placements with regular auctions, initially for short-term government securities; then looking to expand repo markets and broaden the investor base.

AUTHORITIES' VIEWS

51. Authorities broadly agreed with the FSAP's assessments and expressed interest in implementation of the recommendations. However, they noted that recommendations that require changes to legislation are challenging in the current political environment, and some could be limited by legal constraints. Recommendations with budgetary or government financing implications would need to be carefully sequenced given fiscal challenges.

52. The authorities pointed to the stability of the financial sector during the pandemic period and the market exit of a significant number of unviable cooperatives as positive signs. However, they agreed that the combination of falling oil prices and tightening global financial conditions in the adverse scenario would be challenging. Authorities agreed with the analysis of the liquidity stress test and noted that the liquidity fund was mostly invested in international liquid assets and would be available *in extremis*. The implications of a broader move by banks and the deposit insurance fund to holding more international liquid assets for the stability of the dollarized system, which they remain committed to, would need to be considered. In addition, legal limitations on public sector lending to the financial sector could limit some reforms, such as on emergency liquidity assistance.

53. The authorities recognized the challenges for financial sector oversight and crisis management. They highlighted existing initiatives to improve inter-agency coordination and plan to build on these, for example through the forthcoming Financial Stability Report. They agreed with the need to further integrate stress-testing and forward-looking viability analysis into their supervision of banks, mutuals and cooperatives. Addressing shortfalls of resources and recommendations on appointment processes would be more challenging given limited fiscal space. Authorities accepted the case for a reform of the financial institution resolution framework but noted that major financial sector legislation would be politically challenging.

Proposed Decision

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

The Executive Board takes note of staff's analysis and recommendations in the report on Ecuador's Financial System Stability Assessment (SM/23/195, 08/04/2023).

Table 3. Ecuador: Selected Economic and Financial Indicators, 2020–28[1/]

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

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

Table 4. Structure of Financial System, December 2022 [1]			
Institution	**Total Assets**		
	(US$ Mil.)	(In percent of total assets)	(In percent of GDP)[2]
Private Banks (23)	**49,895**	**41.8**	**43.0**
Large Banks (3)	29,347	24.6	25.3
Medium Banks (9)	18,631	15.6	16.1
Small Banks (11)	1,916	1.6	1.7
Public Banks (5)	**14,881**	**12.5**	**12.8**
Development banks (4)	7,891	6.6	6.8
Commercial bank (1)	6,991	5.9	6.0
Cooperatives (467)	**23,509**	**19.7**	**20.3**
Segment 1	19,863	16.6	17.1
Segment 2	1,221	1.0	1.1
Segment 3	2,121	1.8	1.8
Segment 4	1,030	0.9	0.9
Segment 5	439	0.4	0.4
Mutualistas (4)	**1,221**	**1.0**	**1.1**
Total deposit-takers	**89,506**	**75.0**	**77.1**
BIESS	**27,806**	**23.3**	**24.0**
Insurers (28)	**1,221**	**1.0**	**1.1**
Total	**119,410**	**100**	**103**

Sources: Central Bank of Ecuador, Superintendencia de Economia Popular y Solidaria, and Superintendencia de Bancos.
[1] Data for Segment 4 and 5 of Cooperatives and Mutualistas as of September 2022. Banco del Pacifico classified as a public commercial bank.
[2] Data for 2022 Nominal GDP from IMF Spring 2023 WEO.

Table 5. Financial Soundness Indicators (2017–22)

(In percent, unless otherwise indicated)

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

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

Table 6. Ecuador: Implementation Status of Key Recommendations from the 2004 FSAP		
Main Recommendations	**Implementation Status**	**Action Taken/ Comments**
Short-term		
Strengthen bank supervision by introducing: (i) strict adherence to International Accounting Standards; (ii) supervisory training; (iii) legal provisions to guarantee the political independence of the SBS and the legal protection of bank supervisors while performing their duties; (iv) a system for the evaluation of major acquisitions and investments along with fit and proper tests; (v) effective consolidated supervision including off-shore banks; (vi) adequate monitoring of liquid assets held abroad by banks; and (vii) licensed cooperatives, supervised by the SBS, acting as wholesale institutions that can facilitate delegated supervision of the cooperatives currently supervised by the Ministry of Social Welfare (MBS).	**Partially implemented**	See financial sector oversight section. Previous TA and discussion with the authorities identified some potential gaps including in the operational independence of banking supervision and the supervision of large cooperatives.
Eliminate regulatory forbearance by (i) enforcing bank loan classification based on information provided by the Credit Registry and requiring higher provisions and capital when necessary; (ii) requiring additional provisions from cooperatives, savings and loans and finance companies under the SBS while monitoring their asset growth and capital adequacy carefully.	**Partially implemented**	See financial sector oversight section. Previous TA and discussion with the authorities have identified some potential gaps including in provisioning practices of cooperatives.
Remove ceilings to interest rates (usury rate).	**Partially implemented**	A methodology to calculate maximum rates based on average bank costs was established in regulation in 2021. As of June 2023, JPRF is not using the methodology to set rate ceilings
Sell Banco Pacífico at market price. If necessary, the BCE might need to undertake responsibility for any contingent liability. Liquidate all closed banks by end-2004.	**Not implemented**	Banco del Pacífico remains a state-owned bank. Prolonged liquidation process ongoing for Banco National de Fomento and Banco Ecuatoriano de la Vivienda.
Strengthen the resilience of less capitalized banks to systemic shocks by gradually raising minimum capital requirements to 11 percent over three years	**Not implemented**	Minimum capital requirements are 9 percent of risk-weighted assets, with no Pillar 2 capital requirements.
Set up a new Liquidity Fund as soon as the contingent credit line from the Latin American Reserve Fund (FLAR) becomes available.	**Implemented**	Liquidity Fund established, managed by COSEDE (the deposit insurance corporation)
Set up a new deposit insurance agency. Give transitory powers to the AGD to complete the pending liquidation process, without further access to new bank contributions.	**Implemented**	COSEDE is responsible for deposit insurance and the management of the Liquidity Fund

Table 6. Ecuador: Implementation Status of Key Recommendations from the 2004 FSAP (concluded)

Improve the efficiency of the payment system by (i) improving the legal framework and clearly defining the BCE's responsibilities as manager of the payment system; (ii) avoiding the simultaneous presence of both gross and net systems for large value transactions settlement.	**Partially implemented**	COMyF entrusts the BCE with the operation of the central payment system. There is no dedicated system or special procedure for settlement of large-value transactions. No system is formally designated as systemically important. The BCE began implementing a real-time gross settlement (RTGS) system; however, it has not yet developed system rules.
Improve the allocation of resources by (i) revising the 2001 reform of the pension system; (ii) implementing the proposed reform of state-owned development banks; (iii) repealing the many regulations that impose a segmentation of the capital markets between Quito and Guayaquil; (iv) imposing international accounting and auditing standards on large non-financial corporations; (v) increasing the liquidity of the government bond market by standardizing new issues.	**Partially implemented**	The implementation of Sistema Unico Bursatil contributed to solving the segmentation between capital markets. There has been little progress on corporate audits and on standardization of government securities.
Keep the Bank of the Estate of Ecuador (BEDE) within the limits of its mandate as a bank that lends to and takes deposits from municipalities.	**Implemented**	BDE has continued to lend mostly to local governments and receive funding from funds under administration, deposits at regulated rates and foreign development partners.
Strengthen creditor rights and bankruptcy procedures. Introduce the necessary legal reforms to make bank exit policies more efficient.	**Partially implemented**	There have been several reforms to the insolvency and creditor rights regime, including in 2015, with further reforms pending. Bank resolution regime remains underdeveloped.
Promote the development of insurance services by (i) introducing a more favorable legal, fiscal, and regulatory framework for insurance companies; (ii) making motor vehicle insurance compulsory.	**Partially implemented**	Insurance sector remains small
Formulate a set of explicit guiding objectives for debt management, keep track of the maturity structure and returns of the outstanding debt, and diversify the debt stock across the yield curve.	**Partially implemented**	The authorities have received multilateral and bilateral Technical Assistance towards the development of a Medium-Term Debt Management Strategy.

Table 7. Ecuador: Risk Assessment Matrix		
1. Abrupt global slowdown or recession	**Medium** • Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation.	**High** • An abrupt global slowdown or recession could cause a severe drop in economic activity in Ecuador via direct trade effects—China, the U.S. and Europe are Ecuador's largest trading partners—and indirect effects stemming from a wider growth slowdown in the Americas. • Lower commodity prices would impact the fiscal sector and cause pressure on Ecuador's balance of payments. • The lack of an FX-adjustment mechanism would generate a protracted economic slowdown, with ensuing increases in unemployment. • An increase in sovereign spreads, would add to fiscal difficulties. The sovereign-bank loop that originates from public bank ownership and from the holding of public debt by private banks could trigger a downward spiral. • Under this environment, an increase in default rates would dent on bank solvency ratios. Under a low-probability but still plausible scenario, concerns on banks' solvency could affect the stability of their funding, with potential systemic stability implications.
2. Systemic financial instability	**Medium** • Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing markets dislocations and adverse cross-border spillovers.	**Medium** • Higher risk-aversion and tighter global financial conditions would lead to capital outflows from vulnerable EMDEs, with adverse effects on their economies and financial systems. Ecuador would be affected by the adverse financial environment and by real spillovers from trading partners. • Lower commodity prices would impact the fiscal sector and put pressure on Ecuador's balance of payments. • The small cross border liabilities of banks and nonfinancial corporations, and the limited integration with global capital markets would dampen the adverse effects on the domestic financial system.

[1] In line with the February 2023 G-RAM.
[2] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. 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.

Table 7. Ecuador: Risk Assessment Matrix (continued)

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
	(High, medium, or low)	(High, medium, or low)
3. Commodity price volatility	**Medium** • A succession of supply disruptions (e.g., due to conflicts and export restrictions) and demand fluctuations (e.g., reflecting China reopening) causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	**Medium** • Uncertainty on commodity prices will affect investment and economic activity. Financial conditions will tighten, leading to higher funding costs for banks and non-financial corporations. • Credit quality would deteriorate, with potentially adverse consequences on bank solvency. • Fluctuations in commodity prices would impact the fiscal sector and Ecuador's balance of payments.
4. Intensification of regional conflict(s)	**High** • Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems.	**Medium** • Difficulties in finding new markets for agricultural exports that were hit by the supply chain disruptions (banana, shrimp, flowers) can slow economic growth. • An increase in oil prices would tend to improve Ecuador's balance of payments and the fiscal situation, leading to a drop in sovereign spreads that could counterbalance tighter conditions in global financial markets. • Commodity exporters in Latin America, which include key trading partners, would also benefit from higher commodity prices. • Positive spillovers from the oil industry to other sectors would help counterbalance the effects of a global slowdown and tighter global financial conditions.
5. Social discontent	**High** • Supply shocks, high inflation, real wage drops, and spillovers from crises in other countries worsen inequality, trigger social unrest, and give rise to financing pressures and damaging populist policies with possible spillovers to other EMDEs. This exacerbates imbalances, slows growth, and triggers market repricing.	**High** • Uncertainty regarding future macroeconomic policies could lead to increases in interest spreads and affect private investment and economic activity. • Adverse feedback loops between the real, financial, and external sectors, could deepen the downturn, weakening credit quality and leading to potential instability in bank funding.

Table 7. Ecuador: Risk Assessment Matrix (Concluded)		
Nature/Source of Main Threats	**Overall Level of Concern**	
	Likelihood of Severe Realization of Threat in the Next 1–3 Years	**Expected Impact on Financial Stability if Threat is Realized**
	(High, medium, or low)	(High, medium, or low)
6. Cyber threats	**Medium** Cyberattacks on critical physical or digital infrastructure trigger financial and economic instability.	**Medium** • Significant disruption to payment systems could threaten confidence in the banking system and bank supervision. • Direct losses caused by cyberattacks and adverse confidence effects could lead to deposit instability, increasing banks' vulnerabilities to a run and raising their funding costs.
7. Extreme climate events	**Medium** • Extreme climate events cause more severe than expected damage to infrastructure (especially in smaller vulnerable economies) and loss of human lives and livelihoods, amplifying supply chain disruptions and inflationary pressures, causing water and food shortages, and reducing growth.	**High** • Ecuador is vulnerable to a wide range of natural hazards related to climate change, such as landslides, floods, storms, and the effects of the El Niño and La Niña climate phenomena. Ecuador is also exposed to volcanic and seismic activity. • A severe natural disaster would cause higher NPLs on banks' loans to borrowers in affected regions, affecting bank profitability and solvency. Such disasters could also hit production (including in the oil sector) with knock-on effects to the fiscal and financial sectors.

Appendix I. Stress Testing Matrix (STeM)

Domain		Assumptions Top-down by FSAP team
Banking Sector: Solvency Stress Test		
1. Institutional Perimeter	Institutions included	• All banks (24 institutions with total assets equivalent to about 57 percent of GDP) and the cooperatives of Segments 1 and 2, comprising 96 institutions with total assets of 16 percent of GDP. In addition, the cooperatives of Segment 3, with total assets of 0.9 percent of GDP, were assessed at the aggregated level.
	Market share	• About 98 percent of total financial system assets.
	Data source and starting date	• Data Sources: Supervisory returns, data from the credit registry, special requests to banks and publicly available data. • Baseline date: Balance sheets as of December 2022. • Scope of Consolidation: Consolidated bank balance sheets.
2. Methodology	Overall framework	• Credit risk assessed with two methodologies: SB balance sheet-based model and a credit VaR using monte carlo simulation to compute expected and tail credit losses. These two models were complemented with sensitivity analysis assessing the impact of individual risk factors. • The credit portfolio was split in five main credit types: mortgages, SMEs, consumer, commercial and student loans. In addition, concentration risk was assessed with a separate assessment of individual bank exposures to the 100 largest borrowers in the system, using a fully integrated bank-corporate stress test. • The corporate stress test exploited information from their financial statements, applying the same baseline and stressed scenarios used to stress the banking system. Corporate borrowers were classified by their main economic activity. Shocks were sector-specific, using the International Standard Industrial Classification of Economic Activities (ISIC).
	Satellite models for macro-financial linkages	• Satellite models based on previous IMF TA linking bank-specific PDs for the five types of credit to a set of macroeconomic variables comprising GDP growth, interest rates, unemployment, and other macro variables. • Net interest income based on dynamic panel econometrics.
	Stress test horizon	• 3-years (2023–2025).
	Assumptions	• Passive balance sheet assumption: (i) total assets and credit evolve as a function of nominal GDP growth; (ii) the composition of the asset side of the balance sheet remains constant throughout the stress test horizon; (iii) banks build capital through retained earnings; and (iv) bank deposits adjust as needed to close the accounting identity. • Dividend distribution allowed if net income after taxes is positive and if banks are adequately capitalized, with a buffer of at least 4 percentage points above the regulatory minimum. The dividend payout ratio is assumed to be 50 percent.
3. Type of analyses	Scenario analysis	• Scenario-based stress tests focus on the impact of the macroeconomic environment on credit risk, COVID-related credit losses, and concentration risk. • Given the domestic orientation of banks, the scenarios focus on domestic macro-financial variables (e.g., GDP, interest rates, unemployment rate, and sovereign spreads). • To account for the differential impact of COVID across businesses, the scenarios simulate the evolution of value added by economic sectors. These sectors were grouped in three categories to differentiate their sensitivity to the pandemic. • Two macroeconomic scenarios were simulated at the yearly frequency, using MCM and RES models:

Domain		Assumptions Top-down by FSAP team
		• Baseline scenario: The baseline uses the April 2023 WEO projections. It assumes a weakening external environment, with oil prices easing gradually and global demand extending a slowdown. Financial conditions are affected by the tightening of monetary policy in industrial countries and appreciation of the US dollar relative to the euro and other major currencies. On the domestic front, the baseline assumes the orientation of economic policies will remain unchanged. • Adverse scenario: A sharper than expected slowdown in China combined with a tightening of global financial conditions. This scenario entails a drop in oil prices and a slowdown of external demand that impacts economic activity and the fiscal sector. This effects, combined with an interest rate increase in industrial countries triggers a spike in Ecuadorian sovereign spreads. The lack of an FX-adjustment mechanism leads to a severe and protracted drop in economic activity, and an increase in unemployment, hitting household income and generating second round effects between the real economy and the financial and fiscal sectors. The materialization of this scenario is deemed to depend mostly on external conditions, in particular a sharp slowdown in China and in industrial economies.
	Sensitivity analysis	• Sensitivity analyses to complement the scenario-based analysis. The risks comprise: • Credit risk from reclassification of loans between risk categories. • Reclassification of refinanced or restructured loans.
4.Risks and Buffers	Risks assessed	• Credit risk and sovereign risk. • Interest rate risk in the banking book, compression of interest margins.
	Buffers	• Existing loan loss provisions and capital buffers. • Internal capital generation (i.e., income after taxes). • No new capital injections.
5. Regulatory Standards	Regulatory Standards	• National regulatory framework (Basel I). • Hurdle rate 9 percent on Basel Capital Adequacy Ratio.
6. Reporting Format for Results	Output presentation	• System-wide capital shortfalls from macroprudential perspective. • Number of banks and percentage of banking system assets by CAR intervals. • Impact of shocks on NPLs. • Impact of shocks on key P&L components.
Banking Sector: Liquidity Stress Test		
1. Institutional Perimeter	Institutions included	• Six banks that participated in an LCR-pilot project.
	Market share	• About 60 percent of total financial system assets.
	Data and Starting position	• Cut-off date: December 2022. • Data Source: Supervisory returns and pilot project data on liquid assets and liabilities, and projected cash flows at 30 days. High Quality Liquid Assets classified by main counterparties and by jurisdictions (i.e., domestic versus foreign).
2. Methodology	Overall framework	• Cash-flow cum counterbalancing capacity-based liquidity stress test. • Proxy of the Basel III-LCR ratio.
3. Type of analyses	Scenario analysis	• Three scenarios combining Basel recommended weights on liabilities with three assumptions on asset haircuts.

Domain		Assumptions Top-down by FSAP team
4. Risks and Buffers	Risks	• Cash-flow based LST. Outflows on deposits and other liquid liabilities combined with reduction of asset liquidity.
	Buffers	• Cash-flow based LST: Capacity of banks to generate liquidity from assets under stress (counterbalancing capacity). • LCR of 100 percent at all times over 30–days.
5. Regulatory Standards	Regulatory Standards	• The LCR not yet implemented in Ecuador. Hurdle rates followed the Basel III recommended 100 percent for LCR.
6. Reporting Format for Results	Output presentation	• Distribution of banks and total assets by intervals of LCR after shock.
Corporate Stress Test		
1. Institutional Perimeter	Entities included	• The sample comprises the largest 100 corporate borrowers.
	Data	• Publicly available financial data on corporations, including balance sheets and profit and loss statements. Corporate stress test fully integrated with the bank stress tests by matching corporate borrowers with their lender banks and exploiting bank data on outstanding credit amounts, provisions and credit risk mitigants at the level of the lender banks.
	Time Horizon	• Corporate-level data are unbalanced, during 2015–21.
	Overall framework	• Stress test based on the ICR and Earnings Before Interest and Taxes, Depreciation and Amortization (EBITDA) conditional on the baseline and distressed scenarios applied to the bank stress tests. • Individual firms are classified by their economic activities and subject to the adverse scenarios used in the bank stress tests. The shocks include an increase in interests on short-term debt and maturing long-term debt, and a drop in EBITD proportional to the evolution of value added in the sector where the firm operates. • Individual firms are mapped to their lender banks, and the results used to inform the bank stress tests of credit risk.
	Scenarios	• The analysis applies the same baseline and distressed scenarios used in the bank stress tests. The corporate stress test uses projections of sectoral value added and shocks to sovereign spreads and interest rates to come up with a set of firm-specific shocks consistent with the bank stress tests.
3. Risks and Buffers	Risks	• Insolvency risk.
	Buffers:	• EBITDA and capital.
4. Reporting Format for Results	Output presentation	• Total assets and number of firms with ICR below 100 percent by economic sectors, and lender banks, under baseline and distressed scenarios. • Total bank debt owed by firms with ICR below 100 percent, by lender banks, under baseline and distressed scenarios. • Total bank debt owed by firms with negative EBITDA or negative equity, by lender banks, under baseline and distressed scenarios.

Domain		Assumptions
		Top-down by FSAP team
Financial System: Interconnectedness Analysis		
1. Institutional Perimeter	Institutions Included	• Interbank network: All 24 banks and the cooperatives of Segments 1–3.
	Data	• Data source: Supervisory data on interbank exposures and cooperative deposits in the banking system. • Interbank and other relevant balance sheet positions as of June 2022.
2. Methodology	Overall framework	• Interbank: Balance sheet-based interbank model by Espinosa-Vega and Solé (2010). • Common exposure: balance sheet approach.
3. Risks and Buffers	Risks	• Credit and funding losses related to interbank exposures. • Default of large common borrowers in the banking system.
	Buffers	• Interbank network: banks' own capital and liquidity buffers.
4. Reporting of Results	Output presentation	• Interbank network: a network chart, index of vulnerabilities. • Evolution and direction of spillovers.