

**STRENGTHENING OF THE STRUCTURE FOR DELEGATED REGULATION AND SUPERVISION
OF CREDIT UNIONS IN PERU**

(TC-99-05-05-2)

EXECUTIVE SUMMARY

Executing agency:	Sector Project Coordination Unit (UCPS) within the Ministry of Economic Affairs and Finance
Project number:	TC-99-05-05-2
Beneficiaries:	The Superintendency of Banks and Insurance (SBS) and the National Federation of Credit Unions (FENACREP) and Peruvian micro and small enterprises
Financing:	Nonreimbursable (III-A) MIF: US\$1,000,000 Local: US\$ 660,000 Total: US\$1,660,000
Objectives:	<p>The general objective of the project is to improve access to complete (savings and loan) services for small and micro enterprise operators in Peru, with special attention to those in the interior of the country, where the coverage of the banking system is very weak. The project is intended to strengthen the integration of credit unions (COOPACs) into the structure for prudential supervision that applies to the rest of the national banking system. The specific objectives are: (i) to reform the prudential standards for credit unions (COOPACs); (ii) to strengthen the delegated operating structure for prudential regulation and supervision for COOPACs through the National Federation of Credit Unions (FENACREP), and (iii) to strengthen the capability of the Superintendency of Banks and Insurance (SBS) to supervise the operations of COOPACs through a delegated oversight mechanism.</p>
Description:	<p>The Sector Project Coordination Unit (UCPS), within the Ministry of Economic Affairs and Finance will be responsible for execution of the project. The UCPS was set up especially to execute this type of program and is currently executing the parallel Technical Cooperation Operation for the Financial Sector II (PE-0202),</p>

which was designed in coordination with this program. However, given the nature of this program, execution will require the active participation of the Superintendency of Banks and Insurance (SBS) and the National Federation of Credit Unions (FENACREP). The SBS is an institution of the Peruvian government that oversees the stability of the national financial system, including credit unions. FENACREP is a second-tier institution to which inspection and oversight of the credit union sector has been delegated. Given that FENACREP acts both as a representative of the sector and a delegated supervisor, it was decided that the MEF should be the executing agency and that the SBS and FENACREP should be the coordinating institutions. The project would rationalize and strengthen the structure of delegated prudential regulation and oversight now being exercised by FENACREP by decision and under the supervision of the SBS.

Under the delegated oversight arrangement the SBS will continue to oversee credit union compliance with prudential standards, as it does for the other institutions within its purview. However, to alleviate the SBS's budgetary burden for such oversight, information gathering and field work have been delegated essentially to FENACREP. The credit unions must pay an annual fee to cover the greatest possible percentage of the supervision system's operating costs.

The SBS will design the prudential standards with technical assistance support from the project, and the supervision and inspection technology will be transferred to FENACREP. The SBS will supervise the oversight and inspection work of the Federation to ensure that the requisite quality standards are being upheld. All financial, statistical and qualitative information required by the SBS will be gathered and processed in accordance with SBS specifications, and then transferred to that entity by the Federation on electronic media. The SBS will assign the necessary technical staff to monitor the financial condition of the COOPACs supervised by FENACREP. The standards will include sanctions for noncompliance with the prudential standards, including the takeover and liquidation of credit unions, in keeping with the same policies and procedures followed for other intermediaries on the market.

**Execution
timetable:**

Execution period:	36 months
Disbursement period:	42 months

Risks: The principal risk generally encountered in prudential supervision is an inability or reluctance to back standards up with clear and forceful sanctions to ensure compliance. Without such sanctions, the rules will become a mere piece of paper, for the COOPACs will feel no necessity to abide by them. However, the new law on credit unions, through Resolution SBS No. 0540-99 of July 15, 1999, decreed clear, severe, and decisive sanctions with respect to the purpose and scope of supervision, authority, and applicability, among other provisions.

The cost of prudential supervision requires a compulsory fee system, given that the financial intermediaries would not voluntarily pay the supervision fees. Moreover, current fees are not high enough to cover the basic needs of a proper supervisory structure. The project would make investments to improve the system of prudential supervision, which could be lost if the Federation lacks the financial capacity to fund these recurrent costs once the execution period has ended.

Special contractual conditions: Prior to the first disbursement, a Coordination Committee will be set up between the MEF, the SBS, and FENACREP to administer the project.

In addition, within three months after signature of the agreement, FENACREP must present a feasibility study to justify a change in the level of supervisory fees paid by the credit unions consistent with the higher level of costs to be incurred by the Federation for this activity.

The SBS must design and implement a policy on sanctions for FENACREP and the COOPACs in the event of noncompliance with prudential standards, and the Federation or the COOPACs must define a framework for their application.

Exceptions to Bank policy: None

I. BACKGROUND

A. Eligibility

- 1.1 The project is compatible with the MIF (III-A) guideline for the development of small and micro enterprise, for section 4 of the establishing agreement provides that grants for technical cooperation may be made to financial intermediaries to expand the volume and scope of the services to be rendered to micro and small enterprise. Peru was declared eligible for all MIF facilities on December 14, 1993.

B. Frame of reference

- 1.2 Credit cooperatives (COOPACs) have been developing in Peru's financial market since the mid-fifties. COOPACs perform essentially the same functions as the rural and municipal credit unions, but have not been subject to the same regulation or received the same institutional support from the government. This has made them the weakest link in the financial system, as came to light with the bankruptcy of more than thirty of these cooperatives in the 1992 crisis. At present, and despite this experience, the COOPACs still do not have a regulatory framework as do other financial institutions in Peru.

1. Background and present situation of the COOPACs

- 1.3 The first credit cooperatives in Peru were set up in the mid fifties and developed so rapidly that in 1964 they held 17.3% of national savings. This proportion was reduced to about 1% of national savings by the cooperative system's first crisis in 1980. The system was reactivated in 1981, but in 1992, there was a new crisis, this time largely triggered by the excessively tight monetary policy pursued by the Peruvian government in its war on inflation (which was reduced from 410% in 1991 to 73.3% in 1992). The savings held by the COOPACs again dropped to less than 1% of national savings. During the latter crisis the cooperatives suffered losses estimated at US\$120 million, and more than 30 of them went bankrupt.
- 1.4 In recent years the COOPACs have recovered part of the ground they lost in the 1992 crisis, but by 1998 the savings they held came to only 2.5% of the national total. On the other hand, the total assets of the 198 cooperatives operating at the end of 1998 came to 755.02 million new sols (US\$248.36 million), or 1.08% of the assets of the Peruvian financial system. By comparison, the total assets of the 14 rural credit unions and 14 municipal credit unions amounted to 0.35% and 0.68%, respectively, of the same system. As far as growth rates are concerned, in 1997 and 1998 the assets of the COOPACs grew 17.5%, compared with only 14.7% for the assets of the commercial banks. This situation shows that, while the relative weight of the COOPACs in the financial system is not very great, there is a rising demand for its services in a sector whose access to the traditional banks is being made increasingly difficult.

2. Regulatory framework of the COOPACs

- 1.5 Until 1992 the regulatory framework of the COOPACs was the Single Organized Text (Texto Único Ordenado) of the General Law on Cooperatives (LGC) No. 074-90-TR. In the wake of the crisis of 1992 the Peruvian government dissolved and liquidated INCOOP by decree-law No. 25879 and decided that the COOPACs would thereafter be under the control and supervision of the SBS.
- 1.6 When the COOPACs came under the control of the SBS, they became subject to the LGSFS. This law divides the COOPACs into two categories: credit cooperatives authorized to obtain resources from the public, and those not so authorized. Article 282 of the LGSFS defines COOPACs authorized to receive resources from the public together with the other enterprises of the financial system. These cooperatives must take the legal form of cooperative stock companies, are not subject to the LGC, and are supervised by the SBS.
- 1.7 The COOPACs not authorized to operate with third parties are covered in the twenty-fourth of the Final and Complementary Provisions of section five of the LGSFS. In that section the SBS provides that the COOPACs will be supervised by the National Federation of Credit Unions of Peru (FENACREP), which is authorized to impose measures on cooperatives in difficulty, gather information, perform audits, and set up a contingency fund for the support of its associated cooperatives. In turn, FENACREP is supervised and controlled by the SBS, which regulates the operations of the COOPACs. In this work of regulating the cooperatives the SBS is authorized to obtain information on the COOPACs from FENACREP, to hold inspections, and to impose measures.
- 1.8 This regulatory framework of the COOPACs not authorized to receive resources from the public suffers from many defects: first, the Regulations on Operations and Supervision contain major lacunae, such as the absence of a ceiling on minimum capital stock, failure to spell out many prudential ratios (risk coverage, liquidity, filling of posts, loans to directors, etc.), and a lack of clear rules on the dissolution of cooperatives, among others. Second, not being covered by the Deposit Insurance Funds, the COOPACs are forced to set up their own contingency funds. Third, the SBS justified its decision to delegate supervision of the COOPACs to FENACREP on the pretext that they receive contributions only from their members. However, entrusting the supervision of these cooperatives to FENACREP under the existing regulatory framework weakens the structure for prudential supervision of the COOPACs because FENACREP's structure is protective by nature and it lacks both the material and the human resources needed to perform this function. For all these reasons, the COOPACs not authorized to receive resources from the public are at a disadvantage relative to the other institutions of the Peruvian financial system.

3. The National Federation of Credit Unions of Peru (FENACREP)

- 1.9 FENACREP is a nonprofit association of 122 COOPACs. According to Article 1 of the FENACREP charter, the functions of this association are "...to engage in activities of representation, control, defense, and financial and educational technical assistance, and in economic-financial and social services...". FENACREP does not engage in financial intermediation or receive resources from the public. Its primary source of income consists of supervision fees that COOPACs must pay since they were authorized by the SBS, in resolution 453-94, as a means to make FENACREP self-supporting.
- 1.10 FENACREP has two operational divisions under its General Manager: the Supervision Unit and the Technical Assistance and Training Unit. There is also an Administration and Finance Unit, and a small printing office that prints its bulletins, etc. In 1997 FENACREP had a staff of 15 employees, plus two representatives of the SBS to provide technical support. The Supervision Unit has two areas: the Evaluation and Control Area, with a staff of two, and Inspections, consisting of a senior-level professional and two assistants. It is plain that this structure is inappropriate for the supervision and control of the more than 200 COOPACs existing in Peru, which are dispersed throughout the country, mainly in rural areas.

II. THE PROJECT

A. Objectives

- 2.1 The general objective of the project is to improve access to complete financial services (savings and loan) for the low-income population, which operates the small and micro enterprises in Peru, with particular emphasis on the inhabitants of the hinterlands, where coverage by the banking system is very weak. The idea is thus to strengthen the integration of the credit cooperatives (COOPACs) into the structure of prudential supervision that covers the rest of the country's banking system. The specific objectives are: (i) to reform the prudential standards that govern the operations of the COOPACs; (ii) to strengthen the operating structure for regulation and prudential supervision of the COOPACs delegated to the National Federation of Credit Unions (FENACREP), and (iii) to strengthen the capability of the Superintendency of Banks and Insurance (SBS) for supervision of COOPAC operations through a mechanism for delegated supervision.

B. Project description

- 2.2 The purpose of this project is to strengthen the rules and also the structure for prudential supervision and inspection of credit cooperatives through a system of delegated supervision. Under this system the SBS will remain responsible for the compliance of credit cooperatives with the rules of prudence just as it is for the

other institutions under its jurisdiction. However, to ease the budgetary burden of this supervision on that institution, the work of compiling information and conducting field inspections is delegated to FENACREP; the cooperatives themselves must go on paying their supervision fees to the Federation to cover the operating costs of the supervision system.

- 2.3 The project for prudential supervision will be carried out in coordination by the SBS and FENACREP. Each institution will administer a separate budget to fund the activities assigned to it, and a Coordinating Committee will be constituted whose members will be appointed by their respective institutions. This Committee will be charged with ensuring that the two institutions execute the project as effectively as possible.

1. Superintendency of Banks and Insurance (SBS)

- 2.4 The project will fund the engagement of two professionals for the SBS. These professionals will see to transfer of the technology of supervision and inspection from the SBS to FENACREP and to monitor compliance with the rules by the COOPACs. The project will finance 100% of the cost of these professionals in the first two years, and 50% of it in the third. The professionals will work in the SBS and are expected to remain with the Superintendency after the project is concluded. In addition, the project will finance the commissioning of two short-term consultancies¹ to support a redesign of the prudential standards and to help rationalize the legal and regulatory framework in which the COOPACs operate. Finally, the project will provide some financing for the purchase of equipment and to temporarily cover some of the SBS's recurrent costs, which will have to be borne in their entirety by the SBS when the project comes to an end.
- 2.5 The SBS will oversee the supervision and inspection work done by the Federation to enforce the requisite quality standards and will assign the experts needed within the SBS to monitor the financial situation of COOPACs supervised by FENACREP. The standards provide sanctions for noncompliance with the prudential standards, including the intervention and liquidation of credit cooperatives, in accordance with the policies and procedures applied to other intermediaries on the market. The SBS is the only institution that imposes sanctions on these intermediaries. For the execution of this component to be successful, a series of prudential standards for the credit cooperatives will have to be drawn up and approved.

2. National Federation of Credit Unions (FENACREP)

- 2.6 The project will finance the hiring of an international consulting specialist in prudential supervision for a period of three years. Three additional professionals will be hired as a second team of inspectors to reinforce FENACREP's inspection

¹ The terms of reference for these consultancies are attached to this document.

capability. The project will finance 100% of the cost of this additional personnel in the first two years and 50% of it in the third. When the project ends these professionals will stay on as permanent staff members of the Federation. In addition, the project will finance recurrent costs of the COOPAC supervision work. This component of the project will permit the on-site supervision of 71 cooperatives, which constitute 95% of the active members of the system, once a year.

3. Sustainability of the delegated supervision system

- 2.7 By mandate of the SBS, the Federation currently collects a supervision fee from each cooperative in the system. The structure of these quotas will have to be revised to ensure that, when the project ends in three years, the Federation's income from supervision fees will be sufficient to cover its costs. One of the special contractual conditions under this project will be revision by the Federation of these fees to an appropriate level that will ensure the sustainability of a system of prudential supervision. The Federation will be required to present a budget of its own projected income and expenditure and of those of the Supervision Unit allowing for the additional inspectors to be hired and trained with resources of the Project, and to show that the proposed level of the supervision fees will be sufficient to cover the increase in recurrent costs that will result from execution of the project. The increase in the supervision fees will have to be approved by the FENACREP Assembly as one of the special contractual conditions precedent to disbursement.

III. COST AND FINANCING

- 3.1 The total cost of the project is estimated at US\$1.6 million, including US\$1 million in MIF financing. Most of the MIF resources will finance the acquisition of short- and long-term international consulting services, which will be performed as specialized consultancies and as training for technical staff. Equipment purchases must not take up more than 15% of the MIF resources for the projects. The counterpart contribution will be US\$600,000, at least half of which will be paid out in cash as remunerations for the local technical personnel to be hired for project execution.

Budget of MIF project Delegated Regulations and supervision of COOPACs US\$ thousands				
	MIF (US\$)	SBS (US\$)	FENACREP (US\$)	TOTAL (US\$)
1. L-T Consultancy - international	315			315
5 L-T Consultancy - local	125	150	290	565
2 S-T Consultancy - international	140			140
International travel expenses	50			50
Subsistence	75	20	20	115
Equipment	150			150
Workshops and seminars	75	30	30	135
Other operating expenses	70	20	40	130
Totals	1,000	220	380	1,600

- 3.2 The budget provides for the retaining of a long-term consulting specialist in supervision of financial institutions for assignment to FENACREP. In addition, the Federation will engage three local technicians to increase the institution's supervision and inspection capability. The SBS will hire two local technicians to monitor the COOPACs and oversee the supervision delegated to FENACREP. The SBS will commission international (or local) consultancies for reform of the legal and regulatory framework of the COOPACs and to draw up prudential standards for these financial intermediaries. Payment of the remunerations of the local technicians in the SBS and FENACREP will gradually be taken over by each of these entities as the MIF subsidy for the purpose gradually decreases. Because of the wide dispersal of the COOPACs in the country, the project will acquire transportation equipment and provide financing for subsistence and domestic travel.

IV. PROJECT EXECUTION

A. The executing agency

- 4.1 The Sector Project Coordination Unit (UCPS), within the Ministry of Economic Affairs and Finance will be responsible for execution of the project. The UCPS was set up especially to execute this type of program and is currently executing the parallel Technical Cooperation Operation for the Financial Sector II (PE-0202), which was designed in coordination with this program. However, given the nature of this program, execution will require the active participation of the Superintendency of Banks and Insurance (SBS) and the National Federation of Credit Unions (FENACREP). The SBS and FENACREP will have ultimate responsibility for administering the resources and ensuring that the program is executed as agreed. To facilitate coordination of the activities and roles of the

various institutions, a Coordination Committee is being set up between the MEF, the SBS, and FENACREP.

B. Procurement of goods and services

- 4.2 In keeping with the Bank's policies, procurements of equipment and services using resources assigned to the project may be made only in MIF-eligible countries subject to the principles of economy and efficiency and following competitive and open methods.

C. Status of implementation and conditions for disbursements

The following conditions must be met before the first disbursement is made under the project:

- 4.3 The Coordination Committee between SBS and FENACREP will be set up to administer the project.
- 4.4 In addition, within three months after signature of the agreement, FENACREP must present a feasibility study justifying a change in the level of the supervision fees paid by cooperatives in keeping with the higher expenditures to be incurred by the Federation for the purpose. The Federation's General Assembly must have changed the structure of the supervision fees to keep its supervisory work sustainable without regard for the subsidy to the project during its execution. The project will provide an initial subsidy to cover the additional expenses of this new structure, but the subsidy will decrease 50% in the third year, and starting in the fourth the Federation will have to cover all supervision costs.
- 4.5 The SBS must design and implement a policy on sanctions for FENACREP and the COOPACs in the event of noncompliance with prudential standards, and the Federation or the COOPACs must define a framework for their application.

V. MONITORING AND EVALUATION

- 5.1 A midterm evaluation will be done when at least 50% of the MIF contribution has been disbursed. The specific object will be to assess the extent to which the Federation has been able to fulfill the requirements imposed by the Superintendency of Banks and Insurance and its drafting and implementation of appropriate prudential standards and sanctions. Finally, it is important to evaluate the extent to which the reforms implemented in the collection by FENACREP of supervision fees from the COOPACs will suffice to make the system of delegated supervision financially self-supporting by the end of the project.

VI. JUSTIFICATION AND RISKS

- 6.1 The COOPACs have been growing very fast in recent years, and financing their lending operations with savings obtained from their members. The members of these intermediaries are chiefly middle- and low-income earners. Historically they have been operating outside any structure of prudential regulation and supervision, which has resulted in repeated systemic crises. In addition to placing at high risk the savings of the lowest-income population, they have the potential for creating a fiscal problem for the national government.
- 6.2 The Peruvian government has already taken the first steps to bring the COOPACs into the regulated financial system. Delegating their prudential supervision to the Federation has substantially improved the quality of the information on these financial intermediaries, and to some extent of their management as well. However, the existing shortcomings in the legal and regulatory framework and the institutional weaknesses of FENACREP have hobbled efficient prudential supervision. Execution of the project will deepen the measures and policies that the Peruvian government has been pursuing on its own initiative. Both the SBS and the Federation are interested in remedying the system's deficiencies and prepared to act for that purpose. The project will make the investments needed to improve the system, and strengthening the COOPACs will make it self-sustaining.
- 6.3 The risks of the project have been identified as follows:

The principal risk of any prudential supervision system is an inability or lack of resolve to accompany standards with clearly-stated and forceful sanctions that can convince the supervised institutions to uphold them. The most important weakness of the system until recently was a lack of SBS sanctions for the COOPACs. However, on July 15, 1999, the SBS, by Resolution SBS No. 0540-99, approved regulations concerning cooperatives not authorized to operate with public resources. This resolution significantly mitigates this risk, establishing clear and forceful provisions to govern the operation and supervision of these cooperatives.

The Federation will have to substantially increase its operating income by collecting higher supervision fees for its technical assistance and training services. The project provides financing to upgrade the Federation's structure and technical capacity to improve its services and expand the coverage among the member institutions. This means that the Federation's recurrent expenses will perforce be higher than they need to be today, which will entail a rise in its operating income. Its ability to increase its service income will depend primarily on the quality of its services and on the charging of a fee that is both competitive and adequately remunerative to the Federation. The increase of competition on the domestic financial market and need to adapt to the demands of new prudential standards will generate in the COOPACs increased demand for technical assistance and training.

Moreover, the costs generated by prudential supervision call for a compulsive collection system, for the financial intermediaries would not pay the supervision fees of their own volition. Actually, these fees are at present not high enough to cover the essential minimum needs of a proper supervision structure. The project will make investments to improve the prudential supervision system, which could go by the board if the Federation is unable to finance these recurrent costs after the end of the execution period. Hence one of the special contractual conditions under the project will be a review and increase of the supervision fees to be paid by the cooperatives to a level that covers all total expenses (both direct and indirect) of the Federation's supervision department.

To reduce this risk the project provides for: (i) a midterm evaluation to ensure that the SBS has drawn up and implemented new prudential standards with the sanctions needed to enforce them, and (ii) as a special contractual condition, the Federation must adjust the supervision fees paid by COOPACs in order to minimize the risk of failure to make the system of delegated prudential supervision self-supporting.

**STRENGTHENING OF THE STRUCTURE FOR DELEGATED
REGULATION AND SUPERVISION OF CREDIT UNIONS IN PERU**

General objective:	To improve access to complete financial (savings and loan) services for the low-income population, which operates the small and micro enterprises in Peru, with particular emphasis on the inhabitants of the hinterland where coverage by the banking system is very weak.	
Specific objectives:	(i) to reform the prudential standards that govern the operations of the COOPACs; (ii) to contribute to reform of the legal framework governing the operations of credit unions; (iii) to strengthen the operating structure for regulation and prudential supervision of the COOPACs delegated to the National Federation of Credit Unions (FENACREP), and (iv) to strengthen the capability of the Superintendency of Banks and Insurance (SBS) for supervision of COOPAC operations through a mechanism for delegated supervision.	
Components	Activities	Expected results
Specialized technical assistance	<ul style="list-style-type: none"> Hiring of international consultants to perform the following duties: Long-term advisory services to National Federation of Credit Unions in strengthening the supervision system. Short-term international consultancies to support reform of legal framework and draw up prudential standards for COOPACs. Hiring in FENACREP and two in SBS of three technicians specializing in supervision of COOPACs. 	<ul style="list-style-type: none"> Redesign and implementation of new system delegated supervision and inspection in FENACREP in close coordination with SBS. Reform of legal and regulatory framework governing financial intermediation operations COOPACs on Peruvian market, including reform of sanctions for noncompliance with standards. Institutional strengthening of structure of prudential supervision of COOPACs and expansion of the present coverage of the system.
Program of training and visits to countries having systems of delegated supervision	<ul style="list-style-type: none"> Execution of program of 5 training workshops and seminars a year during the 3 years of project execution, in different aspects of prudential regulation and supervision of cooperatives. Three international training trips by staff members of SBS and FENACREP to different countries in the region to observe a system of delegated supervision. 	<ul style="list-style-type: none"> Training for personnel supervising COOPACs in SBS and FENACREP in latest technologies of prudential regulation and supervision, with emphasis on particularities of COOPACs. Training in countries of the region most advanced in prudential supervision of COOPACs, to observe operation of system of delegated supervision.

PROPOSED RESOLUTION

PERU. NONREIMBURSABLE TECHNICAL COOPERATION TO THE REPUBLIC OF PERU

Financial Sector Reform Program II Strengthening of the Delegated Regulatory and Supervisory Structure of the Savings and Loans Credit Unions

The Donors Committee of the Multilateral Investment Fund

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the Ministry of Economy and Finance of the Republic of Peru, and to adopt such measures as may be pertinent for the execution of the project referred to in Document MIF/AT-___, with respect to a technical cooperation, the purpose of which is to support the strengthening of the delegated regulatory and supervisory structure of savings and loans credit unions included in the Financial Sector Reform Program II.

2. That up to the sum of US\$1,000,000, is authorized for the purposes of this resolution, chargeable to the resources of the Technical Cooperation Facility of the Multilateral Investment Fund.

3. That the above-mentioned sum shall be provided on a nonreimbursable basis.