Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: 25259

IMPLEMENTATION COMPLETION REPORT
(FSLT-70000)

ON A

LOAN AND A POLICY BASED GUARANTEE

IN THE AMOUNT OF US$ 505.6 MILLION EQUIVALENT

TO THE REPUBLIC OF

COLOMBIA

FOR A

FINANCIAL SECTOR ADJUSTMENT OPERATION

12/26/2002

CURRENCY EQUIVALENTS

(Exchange Rate Effective December 26, 2002)

Currency Unit = Colombian Peso

Colombian Peso 2,819.50 = US$ 1.00
US$ 0.00035 = 1.0 Colombian Peso

FISCAL YEAR
January 1 -- December 31

ABBREVIATIONS AND ACRONYMS

AFP	*Administrador de Fondo de Pensiones* (Private Pension Fund Administrator)
BCH	*Banco Central Hipotecario* (State-owned mortgage bank)
BECH	*Bancos Especializados en Credito Hipotecario* (Mortgage Banks)
BR	*Banco de la Republica* (Central Bank)
CAF	*Corporación Andina de Fomento* (Andean Development Corporation)
CAMEL	Capital/Assets/Management/Earnings/Liquidity (a bank rating methodology)
CAS	Country Assistance Strategy
CAV	*Corporacion de Ahorro y Vivienda* (Savings and Loan Corporation)
CF	*Corporacion Financiera* (Finance Company)
DANSOCIAL	Departamento Administrativo Nacional de la Economía Solidaria
CFC	*Compañía de Financiamiento Comercial* (Finance & Leasing Company)
DTF	*Depósitos a Término Fijo* (Average Rate on Fixed Rate Time Deposits)
EFF	Extended Fund Facility (IMF)
FOGACOOP	Deposit Insurance and Resolution Agency for Cooperatives
FOGAFIN	Deposit Insurance and Resolution Agency for Banks and Financial Institutions
FOPEP	*Fondo de Pensiones Publico* (Public Pension Liability Fund)
FSAL	Financial Sector Adjustment Loan
FSAP	Financial Sector Assessment Program
IDB	Inter American Development Bank
IMF	International Monetary Fund
MOP	Memorandum of the President (main loan/project report)
NFPS	Non Financial Public Sector
PBG	Policy Based Guarantee
SBC	*Superintendencia Bancaria de Colombia* (Banking Superintendency)
TA	Technical Assistance
UPAC	Unidad de Poder Adquisitivo Constante (Price based index for mortages)
UVR	Unidad de Valor Real (Index based on real value of mortgages)

Vice President:	David de Ferranti
Country Director:	Isabel Guerrero
Sector Director / Sector Manager:	Danny Leipziger / Fernando Montes-Negret
Task Team Leader / ICR TM:	Krishna Challa / John Pollner

COLOMBIA
FINANCIAL SECTOR ADJUSTMENT LOAN
AND POLICY BASED GUARANTEE

CONTENTS

Project ID: P063643	*Project Name:* Financial Sector Adjustment Loan
Team Leader: John Daniel Pollner	*TL Unit:* LCSFF
ICR Type: Core ICR	*Report Date: December 27, 2002*

1. Project Data

Name:	Financial Sector Adjustment Loan	*L/C/TF Number:*	FSLT-70000
Country/Department:	COLOMBIA	*Region:*	Latin America and Caribbean Region
Sector/subsector:	Banking (47%); General finance sector (37%); Housing finance and real estate markets (6%); Central government administration (5%); General agriculture, fishing and forestry sector (5%)		

KEY DATES

			Original	*Revised/Actual*
PCD: 03/15/1999		*Effective:*	12/07/1999	
Appraisal: 10/01/1999		*MTR.*	11/17/2000	
Approval: 11/18/1999		*Closing:*	12/31/2001	

Borrower/Implementing Agency: GOVERNMENT OF COLOMBIA/ FOGAFIN / SBC
Other Partners: Inter American Development Bank

STAFF	Current	At Appraisal
Vice President:	David de Ferranti	David de Ferranti
Country Manager:	Isabel Guerrero	Olivier Lafourcade
Sector Manager:	Fernando Montes-Negret	Augusto de la Torre (Lead Spec.)
Team Leader at ICR:	Krishna Challa & John Pollner	Krishna Challa
ICR Primary Author:	Manuel Lasaga	

2. Principal Performance Ratings

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HL=Highly Likely, L=Likely, UN=Unlikely, HUN=Highly Unlikely, HU=Highly Unsatisfactory, H=High, SU=Substantial, M=Modest, N=Negligible)

Outcome: HS
Sustainability. L
Institutional Development Impact: H
Bank Performance: S
Borrower Performance: HS

	QAG (if available)	ICR
Quality at Entry:		S
Project at Risk at Any Time:	No	

Preface

This is the Implementation Completion Report (ICR) for the Financial Sector Adjustment Loan (FSAL), for which Loan 7000 - CO in the amount of EUR 477.477 million was approved on November 18, 1999, signed on December 2, 1999, and declared effective on December 7, 1999. The first tranche was released on December 17, 1999 with all tranche release conditions fully met. The closing date of the FSAL was December 31, 2001. The FSAL was amended in February 2001 to authorize the Bank to issue a guarantee in the amount of up to EUR 238.74 million for notes to be issued by the Republic of Colombia in the international financial markets.

The ICR was prepared by Manuel Lasaga (Consultant / Main author) and John Pollner (Lead Financial Sector Specialist, LCSFF). The ICR was reviewed by Krishna Challa (Sector Leader, LCSFP/LCC1C) and Fernando Montes-Negret (Sector Manager, LCSFF). Preparation of this ICR was begun during October 2002. The ICR is based on materials in the project file, interviews with Bank staff involved in project preparation and implementation, interviews with the Borrower's staff in Colombia. The Project Executing Unit in the Ministry of Finance prepared the Project Review from the Borrower's perspective. Comments on the draft ICR received from the Bank reviewers and the Borrower have been largely incorporated into this final version.

3. Assessment of Development Objective and Design, and of Quality at Entry

3.1 Original Objective:

During the 1990s the Colombian banking system went through a process of consolidation and entry of foreign financial intermediaries. Prior to the period of consolidation, the financial system had developed under the specialized banking model according to the following types of intermediaries: commercial banks, active in both retail and wholesale banking; financial corporations (*corporaciones financieras* – CFs) engaged mainly in corporate banking; finance and leasing companies (*companias de financiamiento comercial* – CFCs); savings and loan associations (*corporaciones de ahorro y viviendas* – CAVs, now currently legally named BECHs or *bancos especializados en credito hipotecario*); and a cooperative sector comprised of many small entities. Following a significant economic and legal turmoil in the mid-1990s, that led to closing and restructuring of some major financial institutions, the sector benefited from positive rates of economic growth, considerable improvements in the prudential regulations, strengthened supervision and institutional improvements. A Banking Framework Law approved in 1993 laid the basis for longer term improvements. By early 1999, the system included 33 commercial banks, 14 CFs, 6 CAVs, and 53 CFCs. Consolidation in the industry was contributing to further reduction in the number of intermediaries.

After decades of consistently solid growth and prudent economic management, Colombia entered its worst recession in over sixty years during 1998-1999. GDP growth fell from 3.4% in 1997 to 0.6% in 1998 and -4.2% in 1999. As a result of the economic downturn, the financial system entered a period of substantial stress. Losses in the banking sector were 1.9 trillion pesos in 1998 and 2.7 trillion pesos in 1999 -- in the latter year 75% of losses came from the public banks. The adverse effects were significantly accentuated by turbulence in the global financial markets which affected most emerging economies in 1998. At the same time, domestic interest rates jumped in 1998 to very high levels, which intensified credit woes in the financial system. One of the factors behind the increase in domestic interest rates was the Government's earlier policy of maintaining the exchange rate within a pre-specified band, and together with reduced access to external financing, this led to greater reliance on domestic financial markets thus putting upward pressure on interest rates. Two particularly vulnerable components of the financial system at this time were the CAVs and the cooperatives.

The CAVs or savings and housing loan banks (now known as BECHs) suffered particularly strong financial shocks on account of four factors: (a) the economic downturn including unemployment and variable interest rates put many housing loan borrowers in default with their banks, thus significantly increasing the CAVs level of non performing loans, (b) the high interest rates caused a mismatch on asset and liability yields on CAVs' balance sheets, (c) the recession also depressed real estate prices which had been used as collateral/guarantees to back home loans – with lower real estate values, collateral guarantees were eroded and thus the CAVs had to forcibly provision more income against losses while at the same time those borrowers were denied further access to credit or refinancing, and (d) during the same period, the Constitutional Court ruled that the variable mortgage rate index used by the CAVs, based in part on average interest rates levels, was invalid since an inflation based index should have been consistently used over the years, and therefore this ruling required CAVs and other banks to refund on an ex post basis many of de facto capitalized interest charges to borrowers so as to reduce accumulated levels of higher real loan balances. In response to these challenges, the Government embarked on a series of specific measures to address the immediate problems in the financial sector, as well as the structural reforms needed to enhance the efficiency, competitiveness and risk profile of the banking sector. The Pastrana administration took office in August 1998 with a good diagnostic of the financial sector problems.

Recognizing the seriousness of the issues facing some parts of the financial sector, the Government introduced in November 1998, through an Emergency Executive Decree (referred to as the Emergency Economic Measures), a series of relief measures designed to help the most vulnerable groups affected by the crisis – mainly low income mortgage borrowers and depositors in the cooperatives system (Emergency Decrees Nos. 1998, 2330, and 2331). In May 1999, taking into account the increasingly acute portfolio problems of financial intermediaries, the Government announced a special recapitalization program to be administered by the deposit insurance agency (FOGAFIN). The support was in the form of medium-term loans to the banks' shareholders to be used exclusively to recapitalize the banks. These lines of credit were funded with bonds issued by FOGAFIN which were then applied by the shareholders to the banks' balance sheets as an investment asset along with the equivalent corresponding entry in the capital account for paid-in-capital.

Following these events, the Bank initiated a Financial Sector Assessment Program (FSAP), jointly with the IMF, during the second half of 1999 in order to diagnose financial system vulnerabilities. This was the very first FSAP mission undertaken by both institutions. The FSAP enriched the analysis of the sector, drawing on the Government's earlier diagnosis as well as an in-depth evaluation of banking supervision dating back to 1997, by a Spanish consulting firm.

The new Government sought Bank support for its comprehensive reform program through the Loan. The Inter-American Development Bank (IDB) and *Corporacion Andina de Fomento* (CAF) provided complementary financing to support the financial sector reform program. Although preparation of this loan started in advance of the joint Bank-IMF Financial Sector Assessment (FSAP), the Bank was able to incorporate key findings from the FSAP missions and an earlier T.A. Loan (Financial Markets Development Project) into the preparation of relevant areas of the FSAL. Following the first tranche of the Loan, the Government requested the Bank in place of second tranche disbursements, a policy based guarantee for an equivalent amount. The Government wanted to use the proposed guarantee transaction to support the issuance of Colombian bonds in the international financial markets during the first half of 2001.

Project Objectives (Original)

The objectives of the program supported by the Loan were to avoid systemic risk in the Colombian financial system, engender confidence in the sector, minimize fiscal costs, and promote the longer-term capacity and efficiency of the system in supporting sustainable economic growth. The objectives addressed both the immediate risks associated with financial system stress as well as the challenges faced by the system in the medium to long-term. The principal components supported by the Loan were a macro-economic program that enabled the stabilization and significant reductions in real interest rates and generation of liquidity, combined with comprehensive financial sector reforms to ensure a timely and effective implementation of prudential rules and supervision of financial institutions, including preventive measures, prompt corrective actions, case-by-case resolution actions, measures to facilitate formation of multi-service financial intermediation ("universal banks"), a comprehensive restructuring and/or privatization of public banks, an overhaul of the cooperatives system to put them under sounder guidelines and supervisory framework, and key changes in the housing finance system. Other complementary measures included Law 550 on restructuring agreements for the corporate real sector, strengthening of the deposit insurance system, and a systematic reduction of inflation. The FSAL was viewed by the Government as an important complement to the Economic Emergency Measures adopted in 1998.

The objectives of this project were reasonable and consistent with the Bank's country strategy. The last full Country Assistance Strategy (CAS) for Colombia had been discussed by the Board in November 1997. A progress report on the CAS was issued in October 1999 and presented to the Board at the time of Loan approval on November 18, 1999. The progress report reaffirmed the main objectives of poverty reduction and sustainable growth. The principal elements of the CAS were: promoting peace; promoting rural development; developing human capital; enhancing public sector efficiency; improving infrastructure services; and ensuring sustainable development. The progress report acknowledged the challenges posed by unfavorable international factors – lower commodity prices and volatile capital flows, and the deterioration of the domestic financial sector.

As stated in the MOP, the Bank identified several risk factors that could deter the achievement of the objectives. The first was the risk that the Government would not be able to contain real interest rates in the economy at moderate levels, thus adding to strains on the financial sector and the government's fiscal difficulties particularly in relation to debt servicing. The second was the possibility of significant worsening of the external environment through renewed turbulence in the international financial markets that could disrupt the implementation of the macroeconomic program. A third factor was the likelihood that the Government would not be able to effect the improvements in institutional capacity and resolution procedures, by banking system regulators, in a timely manner.

3.2 Revised Objective:

With the conversion of the Loan (FSAL) to a Policy Backed Guarantee (PBG), a supplementary objective was implicitly (though not formally) added: to maintain Colombia's access to the global financial markets on terms and conditions that would permit a sustainable fiscal stance. In support of this objective, the 1999 CAS Progress Report had recognized that a worsening of the economic situation could lead to financing gaps and temporary problems in accessing external financial markets. However, at the time of Loan preparation, the PBG was not considered because Colombia was not facing constraints in the global capital markets. Even though it had lost its investment grade rating in April 1999, the Government felt that its excellent track record in managing its external debt would have facilitated its access to the global markets. Nevertheless, investor perceptions about overall emerging market risks conspired against the Government's attempts to tap the markets. The PBG was thus designed to support the country's ability to meet its external financing needs.

3.3 Original Components:

In order to achieve its objectives, the program was supported by reforms in the following five areas:

I. Ensuring a satisfactory Macro-Economic Framework

Maintenance of a satisfactory macroeconomic framework as established by the Government in its development program with the goals of achieving stabilization, substantial reduction in the fiscal deficit, and significant reductions in inflation and real interest rates.

In December 1999, the IMF Board approved a $2.7 billion Extended Fund Facility for a three year period. An IDB Fiscal Adjustment Loan was also approved to support the implementation of parts of the macroeconomic program.

II. Strengthening the Legal, Regulatory, and Institutional Framework of the Financial System

In order to avoid a repetition of the problems witnessed in the financial sector, and to set the basis for a healthy development of the Colombian banking system in the future, the Government assured passage of the Framework Law of the Financial System under Law 510 of 1999. The Government also agreed with the Bank to work on a detailed implementation of this law. The principal commitments under this component were:

i. Support required changes in financial sector legislation and regulations to facilitate strengthening of capital adequacy and prudential rules, bank supervision and enforcement (e.g.: via requiring prompt corrective actions and progressively strict enforcement action), reforms to the deposit insurance system, and measures to promote timely, fair and efficient resolution of banks facing financial solvency problems.

ii. Comprehensive institutional strengthening of both the Banking Superintendency and FOGAFIN, the entity responsible for deposit insurance and problem bank resolution.

The existing legal and regulatory framework had served reasonably well in the past, but needed to be reformed and strengthened to take account of potential problems. The new legislative framework put in place in 1999 was to buttress the faculties of the supervisory agencies to implement strong prudential, capital adequacy and risk management rules, and to take strong preventive measures to anticipate and avoid banking problems. The institutional strengthening program for the Banking Superintendency aimed at improving on-site supervision and off-site analysis capabilities. With respect to FOGAFIN, this component sought to support the implementation of modern methods of bank failure resolution when solvency problems were to arise.

Design of the component to strengthen the Financial System Framework:

The design of this component benefited from diagnostic work from several independent initiatives. The Government's financial sector platform announced soon after taking office had pointed to several areas of concern in terms of the cooperatives and the CAVs. An earlier Bank Technical Assistance Loan which had focused on the problems of bank resolution as well as the difficulties of the CAVs provided good grounding for subsequent analysis. The Joint Bank - IMF missions in 1999 associated with the Financial Sector Adjustment Program (FSAP) also added value to the Government's earlier diagnosis of the sector problems. Finally, an in-depth study by a consulting firm from Spain in 1997, which had been commissioned by the Government, focused on the need to strengthen on-site supervision as well as the off-site analysis of financial strength and performance indicators.

The Government's Emergency Economic Measures of November 1998 had already identified casualties in the financial sector, principally the CAVs and the Cooperatives. The CAVs were particularly hit hard due to a combination of defaulting borrowers, high mismatched interest rates, depreciating values of loan collateral which demanded increased recognition of losses, and the past paid interest rate refunds required by the Constitutional Court's ruling with respect to the indexation mechanism which had been used. The recession in 1999 also took a heavy toll on the other financial intermediaries as a result of increased delinquencies of consumer loans as well as further deterioration in the commercial loans portfolio. These problems underscored the need to fortify the institutional framework of the regulatory agencies, the Banking Superintendency (SBC) and FOGAFIN. Both SBC and FOGAFIN were heavily involved in the workout of troubled financial intermediaries: the former through intervention of failed institutions, and the latter through capitalization of weak banks, liquidation of intervened institutions as well as resolution of the government-owned banks. The timing of this Loan was critical in terms of enhancing the capacity of the regulatory agencies to prevent systemic risk. The Bank's involvement in this component was very helpful since at that time the regulatory agencies were preoccupied with a near crisis at hand.

III. Restructuring and Resolution of Government Banks

The Government had put into effect an action plan to achieve resolution and privatization of the main state-owned and "officialized" banks. A considerable amount of groundwork had been developed under this component to support the following Government actions in this area:

i. Formal action to dissolve the *Caja Agraria* and establish a new institution, *Banco Agrario de Colombia*, to be operated on sound commercial banking principles.

ii. Restructuring, recapitalization, privatization and, if necessary, liquidation of state owned and "officialized" banks that were under public sector management.

iii. Formal action to bring to the point or sale or initiate liquidation of each of the major state-owned or officialized banks: BCH, FES, *BanEstado/Banco Uconal*, *Granahorrar*, and *Bancafe*.

iv. Completion of a study to rationalize and increase the efficiency of state-owned second tier financial institutions.

Design of the component to Restructure and Resolve the Government Banks:

This was perhaps the most challenging component of the program. The diversity of institutions and the complexity of their problems combined with legal and political obstacles to their closure conspired against the Government's goal of achieving a quick disengagement of the public sector from financial intermediation. At the same time, there were market failures that justified continued Government involvement in the financial sector but in a less intrusive fashion. The distinction between state-owned and "officialized" was that in the case of the latter category the ownership interest was held by FOGAFIN resulting from some form of intervention by the regulators. On the other hand, there were only six banks which accounted for the bulk of the Government's presence in the sector, plus the second-tier banks which from the start were earmarked for restructuring and consolidation.

Early on during Loan design the Government closed down the *Caja Agraria* and announced plans to establish a new institution, *Banco Agrario de Colombia*, which would respond to needs of the largely underserved rural communities. While the Bank had initially considered that the government would privatize two out of five state-owned and officialized banks, prior to Loan negotiations, the Government made the commitment to bring all of them to the point of sale. And if necessary, they would initiate their liquidation prior to the second tranche release. In view of the severity of the Government-owned bank problems, the design of this component was very relevant in terms of the objectives. At the same time, the Bank's involvement in this area helped to intensify existing pressures for the government to disengage from first-tier intermediation.

IV. Reform of the Cooperatives system and the Housing Finance Sector

The Government program for cooperatives was aimed at rationalizing these institutions into two categories: those that were to remain credit unions for members only (standard cooperatives), and those that were to remain open to non-members offering a broader scope of financial services on a larger scale (financial cooperatives). In view of the seriousness of the housing finance crisis involving the CAVs, the Government was committed to a reform of this sector. The following action steps were agreed on:

i. Adoption by the Banking Superintendency of satisfactory principles, strategy and action plan for licensing and supervision of cooperatives and its implementation through the resolution of existing cooperatives within the new supervisory framework.

ii. Implement relief programs for housing mortgage debtors and ensuring that the full cost in real terms of new housing loans is transparent and that indexing mechanisms for such loans are designed to ensure sustainable payment capacity by borrowers. In support of this initiative the Government would promote the development of securitization of mortgages as well as the issuance of mortgage bonds to facilitate the management of assets and liabilities by housing financing institutions. The latter was implemented via Law 546 of 1999 whereby the State via FOGAFIN provided guarantees for mortgage securities and bonds.

Design of the component to reform the Cooperatives and the Housing Finance Systems:

The deterioration of the cooperatives in the period preceding the Loan had led to strong protests by members who had lost their savings as a result of large losses incurred by the cooperatives. With the Emergency Economic Measures in November 1998, it became apparent that many of the cooperatives could not survive. The Government was also heedful of the need to establish a resolution agency like FOGAFIN for the cooperatives. While the financial condition of the cooperatives was weakening, there were no panic withdrawals by depositors. In many cases the depositors were themselves borrowers from the cooperatives. The situation was not one of urgency, but there was an immediate need to sift through the universe of cooperatives and to focus on the larger multi-active entities in order to bring them on board to the standard financial intermediation regime. The approach taken with respect to Megabanco in this sector was instrumental. In this regard, the Loan appropriately targeted the establishment of satisfactory principles of regulation with respect to the newly created category of financial cooperatives (to be supervised by the SBC), and then to press for resolution of the cooperatives' status as either financial or standard cooperatives, by second tranche. Those that qualified were given a limited amount of time to complete the transition from a standard to a financial cooperative.

The housing sector situation was somewhat more complicated, but again not threatening in terms of systemic risk, thanks in large part to earlier actions taken by the Government. There were several taxing issues. First, the pricing of mortgage loans, which is based on an indexation formula, had been modified on several occasions, which resulted in a gradual shift from an inflation-based to an interest rate-based index. With the surge in real interest rates in 1998, borrowers' payment capacity was thus severely strained. Second, the Constitutional Court ruled in 1999 that the changes to the indexation formula had been invalid and ordered the CAVs to retroactively adjust all balances of outstanding mortgages, with the consequent write-downs in the value of the loan portfolios. And third, the recession triggered a new wave of loan delinquencies thus undermining the financial viability of the CAVs. However, the effects of the recession were not limited to the housing banks. In 1999, past-due loans of the banking system averaged 13.9 percent of total gross loans, or 82.0 percent of capital. With respect to systemic risk, the bigger problem were commercial loans with a past-due ratio of 11.4 percent of total loans, and 36.3 percent of capital; the equivalent figures for mortgage loans were 15.0 percent and 26.8 percent respectively; followed by consumer loans with 19.8 percent and 18.9 percent respectively. Even though consumer loans were the worst performers, their size relative to the banks' capital was much more limited.

The Bank's main concern was to ensure that in the future housing finance would become more transparent and would avoid any automatic capitalization of interest beyond inflation. At the same time, actions being taken to strengthen the financial system framework were already addressing the structural deficiencies of the CAVs inherent in their limited scope, mainly capturing short-term deposits to fund long-term housing loans. One area where the Bank was persistent in its recommendations was the promotion of securitization of mortgage loans as an instrument for managing interest and liquidity risk. This is an initiative where the Bank's participation was instrumental in supporting the housing finance sector.

V. Rationalization of FOGAFIN's Special Financial Sector programs with its primary role in Deposit Insurance and Bank Resolution

In view of the important role played by FOGAFIN in the resolution of financial sector problems, the Bank felt it was important to clearly delineate among the different types of activities that FOGAFIN engaged in, with appropriate firewalls separating each area of operation. The commitments in this component included the following:

i. FOGAFIN's management to ensure that the special programs did not jeopardize its capacity to deliver its core functions.

ii. Clear separation of the funding for FOGAFIN's special programs from those for its mainstream resolution and deposit insurance functions. In view of the drawdown of FOGAGIN's financial resources associated with the resolution of problem institutions, the Government was to make available the equivalent of US$ 200 million to that agency.

Design of the component to rationalize FOGAFIN's activities:

Early on in the process of Loan design the Bank questioned whether the responsibilities of FOGAFIN were sufficiently well delineated. There was also some concern that the criteria and procedures that FOGAFIN would use to recapitalize troubled banks needed to be specified more clearly. The bank resolution operations during 1998 had also substantially drained the reserves of the deposit insurance fund. In fact the agency had to resort to borrowing during that year in order to maintain an adequate liquidity position. The issuance of the FOGAFIN bonds to fund the recapitalization of the private banks had added to the debt service burden of the deposit insurance agency since the bank shareholders had been granted a grace period with respect to the lines of credit they had received for the recapitalization. The goal supported by this component was to safeguard FOGAFIN's fiduciary responsibilities to protect the bank insurance fund from other commitments such as the debtors' relief program or the capitalization and resolution of the public banks. There was also some apprehension that FOGAFIN was being assigned roles that could possibly be in conflict with its fundamental mission to safeguard depositors' funds while assuring the swift resolution of problem banks. Under the program, SBC directives thus clearly identified the different funds administered by FOGAFIN which were separate from the deposit insurance fund.

3.4 Revised Components:

VI. Development of an External Financing plan to Reduce the Fiscal Burden

Shortly before compliance with second tranche conditions was achieved before mid-2000, the Government requested the Bank's authorization to consider instead, using the resources under the FSAL's second tranche to back-stop a policy based guarantee to be provided by the Bank to enhance and support a large issue of sovereign bonds in the international financial markets. Due to unfavorable market conditions, particularly the contagion effects of financial crises faced in other Latin American countries and other parts of the world, Colombia's access to international financial markets was significantly disrupted and its international rating downgraded. This severely diminished the Government's capacity to raise the requisite amounts of long term international resources at a reasonable cost, to achieve the fiscal gap reduction and financial program sustainability required under the IMF program. In response to the Government's request, following a full review of Colombia's proposed macro-economic and financial program as well as the structural elements of the reforms supported under the FSAL, the Bank's Board approved a Policy Based Guarantee (PBG) of up to Euro 238.74 million (the equivalent of the second tranche disbursement for which Colombia gained eligibility) to back-stop US$ 1 billion worth of long term amortizing notes with level payments, issued by the Government.

While all the conditions for second tranche release under the FSAL had been complied with, the PBG added another component in terms of an in-depth analysis of the country's external debt management and financing plan. This additional component was aimed at assuring that the Government had considered all options in terms of the external borrowing program. One of the critical elements in the design of the PBG was the financial structure of the proposed notes in order to optimize the leverage from the Bank's resources, which had been limited to the amount of the expected second tranche disbursement under the FSAL. The eventual successful issue of international bonds totaling about US$ 1 billion provided the country long term external resources from the market during a very difficult period. The prudent financial management approach facilitated by the PBG proved eventually to be most advantageous given that access problems of developing countries in international markets worsened as such market access became increasingly challenging in subsequent years.

3.5 Quality at Entry:

Quality at entry is judged to be Satisfactory. As explained in the previous section, the design of the project objectives was highly relevant in terms of the Bank's Country Assistance Strategy. Preparation of the project was done efficiently by competent and well-experienced teams at the Bank and in the Colombian Government.

The overall design of the Loan components was very relevant in terms of the challenges facing the financial system. As stated in the Board meeting for Loan approval, the Loan was found to be comprehensive, well crafted, and far-reaching. As explained above, the design was supported by ample sector work by the Bank through the earlier Technical Assistance Loan as well as the FSAP, and the Government's own extensive diagnosis of the problems. Monitoring indicators for the program were practical, such as the implementation of new regulations, restructuring and disposal of public banks, and reform of the cooperative sector.

Reviews by the Operations Committee advised that monitorable actions of the Loan should be more clearly defined, in particular, the criteria and procedures that FOGAFIN would follow in problem bank resolution and better indication of how the program would help reduce high real interest rates. In its final form, the program did not specifically set targets for real interest rates, which in view of the volatility of the currency market and the unpredictable nature of external pressures on the financial markets, the Bank appropriately avoided committing the Loan's outcome to a particular real rate of interest. Another issue raised at the Operations Committee was the pace of reforms and whether the Government should pursue a more aggressive timeline, especially with respect to the cooperatives and the public banks. Unfortunately, at the time of Loan design the Government did not yet have sufficient information to gauge the magnitude of the problem. Part of the reforms dealing with new financial sector legislation and regulations were aimed at facilitating the bank resolution process, so that it would not have been possible to call for swift resolution of problem banks since the legal framework that would authorize such actions was not in place yet. On the other hand, pushing the process at a faster pace did not necessarily translate into lower costs since this might have implied liquidating assets of intervened banks at very depressed prices, with ensuing losses to the State.

4. Achievement of Objective and Outputs

4.1 Outcome/achievement of objective:

The outcome and achievement of development objectives of the FSAL is considered highly satisfactory. This is attributed to the quality of design, strong commitment by the Borrower, timely implementation of policies, and persistence of Bank supervision. The relevance of the project's design and efficiency of its implementation contributed to its successful outcome. The PBG component was instrumental in assisting Colombia return to the international financial markets. This section discusses the outcome and achievement of objectives first, and then concludes with an assessment of the implementation experience, and the project's output.

As a result of a modest economic recovery and actions taken under this program, conditions in the financial sector have improved noticeably. Indeed, given the combination of the major financial sector problems during 1999-2001, Colombia faced significant risks of a systemic crisis. In part helped by the preventive prudential mechanisms and forward looking measures supported by the FSAL, the Government was able to avert a crippling crisis similar to the ones that affected several other Latin American countries. Consolidation and resolution of financial intermediaries that had experienced severe stress has resulted in an improvement in their fundamentals. The closure and merger of institutions combined with the clean up of problem assets by other financial intermediaries led to a significant shrinkage of the financial system in real terms. Excluding the public sector banks, total assets of the banking system have fallen from US$52 billion in 1998 to US$35.2 billion in 2001 although part of this change is due to continuous exchange rate depreciations during the period. Profitability has finally returned after a whopping cumulative loss of 88 percent of capital during 1998-2000, which was largely offset through sizeable increases in bank capital helped by FOGAFIN's capitalization program. The overall financial condition of FOGAFIN is now satisfactory, and the institution enjoys good leadership with effective strategic thinking.

During January to June of 2002, the performance of the banking system has continued to improve. Return on equity has averaged 6.5% up from a 1.1% average in 2001. The more favorable outcome in terms of profitability can be attributed in part to increased efficiency defined as the ratio of total operating expenses (net of depreciation) to net interest income plus non interest income. The ratio has fallen from 80.5 in 1999 to 66.2 during the first half of 2002. The combination of increased efficiency and better asset quality should thus lead to higher rates of profitability. With firmer and more sophisticated tools at the disposal of banking regulators, growth of the system should proceed on a more solid footing.

At the time of the design of the FSAL, it was always assumed that the operation needed to be followed up with a second FSAL to address the remaining medium term agenda such as the reform of the second tier banks, medium term measures to improve capital market and debt securities operations, efficient disposal and sale of remaining non performing loan portfolios of intervened banks, and judicial/commercial code improvements to facilitate faster foreclosure and asset resolution processes. While systemic risk has been reduced as a result of the reforms supported by the Loan, the financial system is still not back to full health. The weight of problem loans is likely to continue to be a drag on future growth of the system. In 2001 past-due loans represented 10.9 percent of total loans, down from 13.9 percent in 1999; however in relation to capital, problem loans were an uncomfortably high 55.8 percent last year, although down from 82.0 percent in 1999, explained to a considerable extent by the less than expected growth performance in the last two years and continued security problems in the country. This trend has continued into the first half of 2002. Past due loans averaged 52 percent of capital.

The improvement in problem loans has been concentrated in the commercial and consumer categories, while mortgage loan show little improvement. However, loans classified as C, D, and E, under the new system instituted in 1999, still represent a high percentage of capital, which at mid 2002 had not changed since 2000. The high level of problem or potential problem loans heightens the vulnerability of the system to future economic weakness as well as to significant increases in real interest rates. These trends point to the need to maintain focus on the second round of reforms which were contemplated from the outset and could be supported via a second FSAL operation The achievements under the first FSAL provide an excellent platform on which to base this second round of reforms.

The contributions from the individual Loan components towards the achievement of the overall objectives are summarized below:

Impact of Macroeconomic component on Program Outcome

The successful implementation of the macroeconomic program has contributed to significantly lower inflation, 8.7 percent in 2001, down from 16.7 percent in 1998, and to significantly lower interest rates as represented by a DTF rate of 12.44 percent in 2001, down from 32.58 percent in 1998. In fact, these are the lowest DTF rates in the system since these statistics were first published in the 1980s. The real interest rate implicit in these figures has thus fallen from a high of about 25.0 percent at the end of 1998, to about 2.0 percent in June of 2002. At the same time, the non-financial public sector deficit was lowered to 3.8 percent of GDP in 2001, down from 6.0 percent in 1999.

Selected Indicators	1997	1998	1999	2000	2001	2002 Est.
GDP (% growth)	3.4	0.6	-4.2	2.7	1.4	1.6
Inflation (%)	17.7	16.7	9.2	8.7	7.6	6.0
NFPS (% of GDP)	-2.7	-3.6	-6.0	-3.8	-3.8	-4.4
DTF Rate (%)	24.09	32.55	21.60	12.14	12.47	9.05

Impact of Financial System Strengthening component on Program Outcome

Building on earlier reforms and institutional strengthening of the regulatory agencies, the successful outcome of this component has resulted in lower systemic risk in the financial system. Key contributions of this component to program outcome include:

a. The implementation of new prudential norms has noticeably reduced systemic risk.

The reform of the financial institutions law allowed the SBC to adopt more effective regulations particularly in the areas of asset quality and capital. Industry consolidation and exit of non-viable institutions has improved the health of the system. At the same time, the introduction of new regulations dealing with asset quality and interest rate risk is only a first step toward achievement of the objective. Supervisors are continuously ensuring that financial intermediares are effectively assimilating and applying the new rules which may involves an ongoing learning process for both the bankers and regulators.

b. New standards for swift bank failure resolution have enhanced FOGAFIN's ability to act quickly to stem the spillover effects from bank failures on the rest of the system

Measures to enhance bank failure resolution have been important in terms of reducing the contagion effect on the rest of the system. The absence of any serious deposit runs during the difficult years 1998-1999 is an indication of the effectiveness of FOGAFIN actions. At the same time, the development of the bank capitalization scheme has allowed FOGAFIN to provide a solution to a bank's problems when the fundamentals remained viable. On the other hand, legal impediments still pose a challenge to FOGAFIN's ability to reach closure with respect to intervened institutions. As of December 2001, FOGAFIN was in possession of 38 financial institutions, banks, finance companies, leasing companies, and financial cooperatives. Of these, five were intervened prior to 1995, fourteen during 1996-98, thirteen during 1999, five in 2000, and one in 2001. These figures also reveal sharp reduction in the number of interventions during the past two years.

c. Creation of a "universal" bank framework whereby all intermediares – commercial banks, finance companies, housing finance banks, and financial cooperatives, operate under a single set of rules to be supervised by a single regulator, the SBC, which bodes well for the sustainable development of the financial system.

All financial intermediaries will now be subject to the same standards of safety and soundness. Nevertheless, the SBC needs to closely monitor the activities of financial intermediaries as they seek to diversify their base of operations. For example, housing finance banks will now expand into consumer lending and corporate finance, which are attractive areas to diversify their operational risks; however, venturing into new markets could pose higher than normal risks. The SBC's internal norms on supervision of consolidated entities and cross business activities address these new developments within the structure of the Colombian financial industry.

Impact of Government Owned Banks component on Program Outcome

By noticeably reducing the involvement of the Government in the financial sector, this component of the program is expected to promote the longer-term capacity and efficiency of the system to support sustainable economic growth led by private sector investment. The effects of Government actions to reduce first- and second-tier financial intermediation are as follows:

a. The closure and privatization of government-owned banks has significantly reduced the presence of the Government in the financial system and consequently reduced systemic risk arising from the unsatisfactory performance of public banks. The liquidation of *Caja Agraria* helped resolve one of the most longstanding sources of financial and economic inefficiency and fiscal drain, and provided a basis for building a more sustainable platform for designing financial services to the agriculture sector.

b. The focus of government lending on second-tier intermediation will contribute to a better risk environment by passing on the risk of the ultimate borrowers to the private sector financial intermediaries.

As explained in the section on implementation, some institutions are still in the process of being sold or liquidated. However, the delay in their implementation has been largely out of the control of the Government, which is still fully committed to their final resolution.

Impact of Financial Cooperatives and Housing Finance component on Program Outcome

As a result of Government actions in this area, a financial crisis was averted. The Government's successful management of these problem institutions has enhanced its credibility as an effective regulator of the market. The principal contributions to program outcome under this component are as follows:

a. The restructuring of the cooperatives sector and transferring of financial cooperatives to the supervision of SBC will subject this segment to the same rigorous standards of supervision as other financial intermediaries.

b. Conditionalities under the loan anticipated the problems in the housing system related to the questionable application of the indexing systems, and the attendant risks of the associated excessive capitalization of interest. The changes introduced to correct the indexing problems and the introduction of the securitized mortgage instruments which was indirectly supported by the loan conditions and related technical assistance, also reflect positive contributions. They will enhance the ability of financial intermediaries to spread the risk of their loans to a wide spectrum of long-term investors, and help reduce systemic risk from the interest rate gap between assets and liabilities.

Impact of the component to Rationalize FOGAGIN, on Program Outcome

Following an organizational restructuring and formal separation of its deposit insurance role from the other financial relief programs administered by FOGAFIN on behalf of the Government, the bank resolution agency should become more effective in dealing with potential systemic problems.

The separation of FOGAFIN's activities will help to keep the institution more focused on the individual areas of risk, especially the resolution of problem banks, while maintaining separate procedures to handle its standard deposit insurance functions.

4.2 Outputs by components:

The overall implementation rating is considered Satisfactory as elaborated below by objectives and program components.

Implementation / Output of the Macroeconomic component

The Colombian Government has maintained its commitment to fiscal adjustment and structural reforms, despite difficult economic, political and security conditions. Compliance with the IMF Extended Fund Facility has been satisfactory. The non-financial public sector deficit was lowered to 3.8% of GDP in 2001, down from 6.0 percent in 1999. Since the Central Bank's decision in September 1999 to abandon the currency trading bank in favor of a free float of the peso, trading in the market has remained orderly; although the peso has depreciated in real terms during this period. The new Government of President Uribe which took office in 2002 has continued to support the same macroeconomic policy framework.

Implementation / Output of the Financial System Framework component

The implementing regulations, policies and procedures put into effect by the Government and its responsible agencies were fully consistent with Loan conditionality. A key Board presentation condition assured early passage of a comprehensive financial sector reform legislation, which in hindsight proved very timely. The Government issued on December 29, 2000 a formal decree (Decreto 2817) putting into immediate effect a system of explicit performance indicators of financial intermediaries which are to be used by SBC to monitor solvency, financial performance or other problems faced by financial institutions. These indicators will form the basis for the CAMEL-type ratings to be applied by SBC in its supervisory activities. The decree specifically provides for prompt corrective actions which will be enforced by the Superintendency of Banks very much in line with the recommendations of the Bank and the IMF. It requires financial institutions, where necessary, to prepare and abide by specific recovery plans approved by the Superintendency to regain financial solvency (*Programa de Recuperacion*, or Recovery Program).

The SBC has begun implementation of new regulations that should help to guard against systemic risk. With respect to asset quality, a new system will be in place by mid 2003 which will place greater emphasis on expected losses based on a borrower's earning capacity. While more sophisticated, the methodology calls for more analysis by banks of a borrower's debt servicing capacity. The SBC is also implementing monitoring measures which take into account deficient management and risk taking practices as part of criteria to assess the condition and sustainability of banks. Implementation of these new methodologies by financial intermediaries will need to be monitored closely by the SBC. With respect to interest rate risk, banks with a heavy reliance on mortgage lending need to be examined closely. It is important to separate interest rate from liquidity risk, and in the case of the former, stress analyses should be based on fluctuations comparable to that that were experienced in the mid 1990s.

The Superintendency of Banks has fully implemented the institutional strengthening program described in Attachment 5 of the Policy Letter. It has provided the Bank periodic reports of the progress of the program. Accomplishments include strengthening of information and diagnostic systems, putting in place a system of early warning indicators and prompt correction measures, integration of findings from off-site and on-site bank examination results, strengthening of loan classification system and provisioning rules, and training programs to enhance the technical capacity of its staff. The Superintendency has also put into effect a major reconfiguration of its organizational structure to facilitate examination and supervision of all constituents of financial groups on a consolidated basis. This step has helped to minimize regulatory leakage via transactions among financial entities belonging to the same economic group. The very positive impact on the quality and effectiveness of supervision is already in evidence.

FOGAFIN has fully respected the principles of problem bank resolution as specified in the Government's Letter of Development Policy contained in the MOP. These include the principles governing distribution of losses, fair burden-sharing among shareholders, creditors and depositors, and using the provisions of its deposit insurance in an integral manner in coming up with the most efficient bank resolution options. FOGAFIN also implemented a very successful private bank recapitalization program to facilitate recapitalization of medium size private banks, fully respecting the principles of burden-sharing and ensuring that existing shareholders assume most of the related financial responsibility. Since the financial sector crisis began in 1998, FOGAFIN has liquidated or is in the process of liquidating a number of institutions, it has entered into a capitalization program with weak banks, and has been charged with the resolution of the public sector banks. The total cost of FOGAFIN's support program during 1998 – 2002 was estimated by Bank staff to be approximately 8,703,733 million pesos, or about US$3.6 billion.

FOGAFIN's role in providing capital support to weak intermediaries is an effective tool in managing systemic risk. Nevertheless, its role in resolution of financial intermediaries which are still going concerns has to be closely coordinated with SBC as the principal regulator of these institutions. Under current practices, FOGAFIN's actions to support any intermediary are decided upon only after extensive informal consultations with SBC. While this collaboration between the two agencies has been a productive one, it might be helpful if in the future FOGAFIN's plans for strengthening a particular intermediary were to be formally approved by the Superintendent or by the Board of SBC.

FOGAFIN also took steps to further enhance its institutional capacity through a consultancy provided by McKinsey and Company. Based on the consultant's recommendations, a new organizational structure created a specialized sub-directorate for asset recoveries, thus resulting in a total of three deputy directorates, focusing respectively on undertaking and overseeing specific problem bank resolution transactions, technical and financial analysis, and management and disposition of bad loans or corresponding assets acquired by FOGAFIN and its affiliates as a result of bank clean-up operations. As a further step related to the latter area, FOGAFIN has recently consolidated under an autonomous affiliate (CISA) the overall responsibility for the non-performing asset management and disposition for the public sector banks.

Implementation / Output of the Government-owned Banks component

The Government has taken a series of bold and forceful actions in following up on the actions referred to in Attachment 2 of the Policy Letter. The Government actions were oriented towards achieving definitive resolution of all the major state-owned and "officialized" banks, including housing finance institutions (CAVs) and cooperatives facing solvency problems. In deciding on the specific mode of resolution, the Government gave first priority to privatizing the institutions wherever feasible, i.e., where the institutions were deemed to be able to achieve solvency and operate as viable institutions in the medium term, and to attract new capital and private investor interest following resolution. Where the judgment of the authorities was in the contrary, actions were taken, within the framework of the banking law, to close and liquidate them or sell their component parts.

Of the six state-owned and officialized banks whose resolution, including privatization (where feasible) and initiation of liquidation, if necessary, was conditioned under the Loan, *Caja Agraria* was formally closed and its entire staff relieved of their duties prior to the release of the first tranche.

Banco Central Hipotecario (BCH) as well as the consolidated package of *Banco del Estado* (*BanEstado*) with *Banco Uconal* ceased all their deposit and lending operations under the Superintendency's orders. The financial resolution of these banks was accomplished by the transfer and/or merger of their good assets and commensurate liabilities with other financial institutions, transfer of BCH's bad loan portfolio to an asset resolution company (CISA) for collection and/or final disposition of repossessed assets, and pursuance of legal steps to formally close the remaining "shell" bank.

BCH was founded in the 1930s as a housing finance institution which focused on the low-medium to medium income market. Inefficient management combined with a significant non performing portfolio forced regulators to close the bank. Good quality assets were transferred to Granahorrar. The formal liquidation of BCH has been announced through a special decree (No. 20 of January 2001). The bank's remaining assets will be sold following the settlement of its pension liabilities.

BanEstado became a state-owned bank during the banking problems in the 1980s. *Banco Uconal*, a cooperative bank that had been intervened in 1998 was subsequently merged with *BanEstado*. The combined bank ceased all deposit and lending operations following the transfer of its good assets to other banks. Due to legal problems arising from a large suit against *BanEstado*, privatization of the combined institution was not feasible. Another complication arose from the fact that some of the *Uconal* creditors held convertible bonds, which further limited the ability of FOGAFIN to liquidate the institution. In fact, the latter issue prevented FOGAFIN from transferring the non-productive assets of the bank to CISA for eventual sale or collection. Currently, the Government is sorting out the legal complexities of this bank in order to resolve its final status. Another institution, FES was intervened in 1999. This was a special purpose fund which had been founded as a non-profit entity to engage in consumer financing. Because of its legal status, FES was handled as a special case by FOGAFIN. It was first converted to a corporation and subsequently liquidated.

Also slated for privatization or winding up, *Granahorrar*, is a savings and loan (S&L) association that has faced progressively increasing difficulties as a result of the deep economic recession and slump in housing prices and sharp deterioration of the situation of the Colombian housing finance sector as a whole. Its planned privatization progressed more slowly than expected due to the lack of buyer interest in the domestic and foreign markets, reflecting the fragile situation of the housing finance institutions. FOGAFIN's Board, consistent with Bank advice, has formally approved an innovative resolution plan. The plan calls for an orderly dismantling of the bank and gradual disposition through the creation of a special fiduciary trust into which *Granahorrar* assets and liabilities will be transferred. The fiduciary will then transfer the management of the assets and liabilities to private banks (initially as an intermediate step if necessary), followed by definitive sale of assets and transfer of commensurate liabilities via a purchase and assumption (P & A) procedure following a market-based competitive process. Non-performing loans from the portfolio were transferred to CISA, the assets management and disposition agency used by FOGAFIN to achieve final disposition of non-performing loans and related assets. Implementation of this plan, which amounts to an orderly dismantling of the institution, has already been initiated, though it will be subject to review based on the interim results of the strategy.

In the case of *Banco Cafetero,* (BANCAFE) its Shareholder Assembly as well as FOGAFIN's Board formally endorsed a proposed privatization plan, and an investment bank was hired to implement the plan and manage the privatization process via open competitive bidding following an initial offer of shares to the solidarity sector (employees) as required by Colombian law. However, towards the end of the process, the investment bank's valuation of BANCAFE, which continued to be affected by major security problems still affecting the country, was considered very low when it was presented to the Council of Ministers at the end of 2001. Due to the unfavorable market conditions, the sale of the bank was postponed. Nevertheless, the Minister of Finance provided the Bank a letter reiterating that if the Government fails to secure a final sale of BANCAFE, the Government would initiate an orderly dismantling process for that bank along the lines already pursued in other cases. Drawing in good part from the previous investment banking work, the new Government which assumed power in August 2002, is now actively renewing a concerted effort to privatize this bank and is currently seeking a strategic investor by 2003, who would purchase 51 percent of the bank after the bank's pension liabilities are transferred to a consolidated public pension liability fund (FOPEP). As the economy begins to strengthen, prospects for the sale of the shares according to this new strategy appear good, and all parts of the Government including the Ministry of Finance, FOGAFIN, and BANCAFE's Management, appear strongly committed to see this through.

Although not a stated objective of the FSAL, as a complementary activity to set the stage for a second round of medium term reforms under FSAL related work, the Government also contracted a consultant to review the status of government-owned second-tier financial institutions. Based on the recommendations of the study, the Government issued a decree calling for consolidation and restructuring of some of the second-tier financial institutions. However, this decree was nullified by the Constitutional Court of Colombia on certain technical grounds which will need to be rectified before moving forward with a new proposal for consolidation and rationalization of the second-tier institutions. The Government intends to formulate a new proposal embodied in Law that is responsive to the Court's decision and the latest developments in the financial sector while enabling the desired rationalization. It is likely that the Government will seek Bank support to complete the rationalization of the second-tier financial institutions via technical assistance or a future lending operation.

Implementation / Output of the Financial Cooperatives component

The supervisory authorities have acted with resolve to ensure that the capital adequacy and solvency rules and prudential regulations applicable to financial cooperatives are clearly defined and fully observed. As part of this process, the Superintendency of Banks undertook case-by-case screening of the financial situation and compliance with the rules of all 54 institutions which were candidates for formal status as financial cooperatives at the time of Loan approval. A number of entities, in the face of the new requirements, either voluntarily withdrew their applications for classification as financial cooperatives or merged with other institutions. The authorities ordered liquidation of the remaining entities that were not able to meet the capital adequacy and other criteria and that were also not able to formulate or comply with a satisfactory recovery plan for transformation into a standard cooperative.

The implementation of the new rules and regulations has noticeably reduced the number of financial cooperatives under the supervision of the banking regulators. Of the original 54 candidates, 23 were transformed into standard cooperatives under the supervision of the special agency for cooperatives, Superintendencia de Economia Solidaria, 11, were intervened and liquidated; 5 were converted to social cooperatives under a special agency (DANSOCIAL); 3 are still in the process of being transformed into standard cooperatives; 2 were merged with commercial banks; 1 was merged with another cooperative; and 7 remain under the supervision of the Banking Superintendency.

Cooperatives not falling under the supervision of the Banking Superintendency (the standard cooperatives), continue to be governed by Law 454 of 1998 and the subsequent relevant decrees and are supervised by specialized institutions created for their oversight, as envisaged under the Program.

In part as a result of the Constitutional Court ruling, the authorities have changed the indexation system for housing finance loans, putting into effect a new system under which housing loans are tied to a reliable inflation index officially certified by the central bank (the UVR index which replaces the old hybrid UPAC index). The new system ensures that the full cost in real terms of housing loans is fully transparent to all parties concerned. The switch to the new indexing systems was also accompanied by the banning of any capitalization of interest payments on housing loans beyond what is implicit in inflation indexing. In other words, an automatic protection against capitalization of interest beyond that attributable to the inflation is embedded in the system. This effectively meets the Loan condition that excessive capitalization of interest is avoided and housing loan contracts are consistent with sustainable payment capacity of borrowers. An additional benefit of the new system has been that a much greater homogeneity in terms of interest rate adjustment methods and amortization options has been achieved in bank mortgage loan portfolios, making them much more amenable to securitization and promotion of medium term mortgage finance instruments.

The Bank and IFC have been working closely with the Government in promoting the framework, regulations and infrastructure for fostering securitization in the Colombian housing finance market and the development of the new medium term instruments, through advisory services, financing of technical assistance and IFC participation in the creation of a securitization company. So far the securitization agency has been able to place about 1.0 billion pesos in securitized mortgage obligations.

In order to assist housing finance banks to deal with interest rate risk, the Bank worked with the Borrower's Central Bank to devise a swap mechanism between inflation-based and interest rate DTF-based indexed instruments. This is really a hybrid swap whereby the participant is compensated only if interest rates go above a certain range and up to a maximum amount. At the same time, the Bank has been looking into the feasibility of a Back-stop facility for issuers of mortgage bonds. With respect to the swap facility, due to the relative stability of interest rates in recent months, there has been no demand for this instrument. On the other hand, the complexity and limited coverage of this instrument, in the face of the relatively high price, may be discouraging banks from participating.

Implementation / Output of component to Rationalize FOGAFIN's Activities

Through an executive decree, the Government formally required FOGAFIN to separate the accounts of each of FOGAFIN's core functions -- problem bank resolution, deposit and other insurance activities-- from emergency relief activities it undertakes on behalf of the Government. Moreover, the Government has strictly abided by the principle that the full costs of resolution, closing or other disposition of state-owned banks (e.g., *Caja Agraria*, BCH, *Banco del Estado)* will be fully met directly by the Government via budget allocations or other funding arrangements. In this context, FOGAFIN's financing for banking sector support was also achieved through the issuance of bonds in the amount of 4.95 trillion pesos, and whose debt service is payable via future budget commitments. The Government also provided evidence to the Bank that they made funds available to FOGAFIN for its regular bank resolution activities. In 1999, 182 billion pesos were transferred to FOGAFIN, 215 billion in 2000, and another 184 billion in 2001, which represented approximately US$ 300 million.

Implementation / Output of Policy Guarantee Component

In May 2001, the Government completed the issuance of US$ 1.0 billion in Notes backed by US$ 158.8 million Policy Based Guarantee from the Bank. With the Bank guarantee the Government was able to place the Notes in the US capital market. The Notes were structured on a level payment amortizing basis for a final maturity of 10 years with the first two payments guaranteed by the Bank on a rolling reinstatable basis.

Thanks to the Bank guarantee the Notes achieved investment grade rating, and 80 percent of the bonds were placed with investment grade investors. The interest rates on the Notes were substantially lower than its previous US$ and Euro-dollar issues, allowing the Government to realize savings of 128 basis points per annum versus its secondary market curve. It the Government had drawn the second tranche under the FSAL and theoretically mobilized the remaining US$ 841.2 million from the capital markets, the cost would have been about 29 basis points over the cost of the guaranteed transaction.

4.3 Net Present Value/Economic rate of return.
Not Applicable.

4.4 Financial rate of return.
Not Applicable.

4.5 Institutional development impact:
The FSAL's institutional development impact is deemed high based on the project objectives of minimizing systemic risk through a strengthening of the financial sector regulatory system and a reduction in the presence of the Government in the financial sector. As discussed in the previous section, the successful outcome in terms of strengthening financial regulations and supervision and the institutional development program of both agencies, SBC and FOGAFIN, not only averted a full blown financial crisis, but supported the long term institutional development of the financial sector. The program supported by this loan has contributed to more effective market mechanisms for financial intermediation. The successful development of the securitization business was an important market innovation spurred on by this loan.

The Loan was instrumental in raising the level of efficiency in three areas: the regulatory environment; the role of state-owned banks; and the resolution of the financial cooperatives and housing finance problems. Within the regulatory sphere the reform program introduced new standards that ensure a higher quality of assets and lower risk of operations as well as a system to measure individual performance by financial intermediaries. The strengthening of the regulatory agencies has made them more proactive in their supervisory functions as seen by the introduction of new norms that have gone beyond the scope of the original program. The reduction in the number of state-owned banks has removed an important source of market inefficiencies. At the same time, the remaining state-owned banks, Caja Agraria and the second-tier banks, are expected to operate under much more intensive accountability standards. Finally, the resolution of the major problems facing the housing finance banks and the financial cooperatives has eased the burden from systemic risk.

Two key reasons why the operation was able to achieve substantial institutional development impact were: (i) the high degree of ownership and commitment the operation was able to generate upfront from the Government and concerned entities governing the operation of financial system; and (ii) the considerable amount of formal and informal technical assistance the Bank was able to arrange during the period of implementation of the loan through financing of complementary activities under an ongoing Financial Markets Development Technical Assistance loan and several non-lending TA activities to provide diagnostic services and advice in a number of related areas such as the design options for low income housing subsidy and guarantee systems, problem bank resolution, possible options for hedging term transformation and index mismatch risks and improved problem bank resolution systems.

5. Major Factors Affecting Implementation and Outcome

5.1 Factors outside the control of government or implementing agency:

One of the main factors outside the control of the Government was the unfavorable external environment. Low commodity prices and the contagion effect from the Asian and Brazilian financial crises as well as the subsequent debacle in Argentina have reduced investment flows into Colombia. Difficulties in neighboring countries (Ecuador and Venezuela) have made the situation worse. These trends have raised the hurdle in overcoming systemic risks arising from liquidity strains on the financial system. On the other hand, reduced investment inflows have conspired against government efforts to privatize some of the public sector banks. In addition, in terms of the bank privatization efforts, there was little demand for bank portfolios, assets, or real estate collateral underlying such bank loans, factors which militated against the quick and expeditious disposal of such portfolios.

5.2 Factors generally subject to government control:

One of the salient characteristics of the successful outcome has been the excellent performance of the Government's macroeconomic policies in reducing inflation to single digits and domestic interest rates to levels not seen in decades. In view of the importance of macroeconomic stability to the sustainability of financial sector reforms, the success of this factor has been instrumental in the overall favorable outcome of the program.

At the same time, the strong "ownership" and commitment to the agreed reform program by the Government, facilitated via thorough discussion upfront on the need and the options for reform, was decisive in its positive outcome. When the Pastrana Administration took office it was already hard at work to define the critical challenges facing the financial sector and to mount a credible policy reform program. During loan implementation, the financial sector authorities diligently executed the prescribed mechanisms for intervention, closure and smooth exit of banks from the financial system, as well as enforcement of capitalization actions.

5.3 Factors generally subject to implementing agency control:

Both SBC and FOGAFIN were strongly committed to the program. Since the passage of the financial sector law, SBC has been pushing to go beyond the initial measures agreed to in the program, such as the recent development of new loan classification standards based on expected cash flow analysis of borrowers, and development of ratings based on bank management performance and internal risk management systems. During the program, the SBC designed and implemented a regime of prompt corrective actions and penalties for non compliance to mitigate a downward spiral in the condition of financial institutions. FOGAFIN has also been persistent in pursuing alternative approaches to the resolution of problem banks and the closure or sale of public sector banks such as the use of securitized instruments to transfer loan portfolios. The use of innovative financial engineering approaches for transferring closed bank balances to acquiring banks (along with burden sharing agreements among all parties), was a key part of the government's strategy as implemented within the new regulatory framework. The high quality of the staff in both institutions can also explain the better than expected implementation experience.

5.4 Costs and financing:

The FSAL's support along with funds provided by the IDB and the CAF, were instrumental in providing a sufficient level of resources to create temporary financial support mechanisms and support FOGAFIN's operations in order to stabilize the financial system.

6. Sustainability

6.1 Rationale for sustainability rating:

The sustainability of the Loan is judged to be likely. The strong commitment by the Government to economic reforms is an important ingredient for continued success of the program in the financial sector. A good track record on macroeconomic policies assures a favorable environment for the sustainability of the Loan objectives. The new Government of President Uribe, which took office in August 2002, has continued to support the same reforms in the financial sector. The regulatory environment continues to improve. SBC is now in the process of implementing new loan classification standards that emphasize the evaluation of future cash flows of borrowers. Improvements in off-site supervision will enhance the capacity to prevent future problems in the sector. The closure and final resolution of public-owned banks is expected to minimize future direct involvement by the Government in the financial sector.

While the financial system has experienced a fundamental improvement in its risk profile, the system is still saddled with problem assets. At the same time, housing finance banks are exposed to the risk of volatile interest rates. In this regard, sustainability of the Loan objectives is somewhat tempered by the risk of future economic problems such as recession, which could lead to a deterioration of the banking system's loan portfolio, or the consequent increased volatility of interest rates could lead to significant losses by banks that are still not adequately hedged.

6.2 Transition arrangement to regular operations:
Not Applicable.

7. Bank and Borrower Performance

Bank
7.1 Lending:
In the identification of the project the Bank showed very good judgment in selecting the development objectives. The Bank was proactive in mounting a series of financial sector strengthening measures to address the problems of the banks' loan portfolios. While the project was complex, the design was compatible with the borrower's capacity.

7 2 Supervision
Bank supervision was highly satisfactory as evidenced by the frequency of monitoring and the attention paid to the compliance with the achievement of the objectives. Bank staff provided good advice to their counterparts in Colombia. As part of project supervision, the Bank also facilitated the provision of considerable complementary technical assistance via a parallel TA loan as well as informal non-lending support to help define implementation strategies and options (e.g. in the development of new housing finance and securitization instruments, options for low income housing guarantee mechanisms, alternative ways of meeting the new mandate from the Constitutional Court, and ways to improve bank resolution and asset disposition).

7.3 Overall Bank performance:
Bank performance was satisfactory. In general the project was well designed and consistent with the Bank's country strategy. Bank staff worked very close with their counterparts in the Colombian Government.

Borrower
7.4 Preparation:
The commitment of the Government to the reform of the financial system and a consistent implementation of risk control measures, was instrumental in the satisfactory outcome of this project. The Government maintained a very positive policy dialogue with the Bank during this initial phase of the project.

7.5 Government implementation performance:
Both Government and implementing agency performance was very satisfactory. The Government was highly committed to the reforms and at the macroeconomic level, maintained strong support from the IMF.

7 6 Implementing Agency:
Implementing agency performance was highly satisfactory. Once the requisite banking legislation was approved, the implementing agencies (FOGAFIN and SBC) immediately applied the new regulatory procedures and resolution mechanisms.

7.7 Overall Borrower performance:
After consideration of the above-mentioned factors and of the outcome of the project, the overall performance of the Borrower is rated as highly satisfactory.

8. Lessons Learned

The principal lessons derived from the outcome of this project include the following:

i. Ample preparatory work, particularly sector analysis, is critical to the success of a Loan. In the case of the FSAL the Government had already started to prepare analysis of the financial sector problems with assistance from the Bank TA Loan. The external consultancy helped to identify key weaknesses in banking supervision; and the Bank's sector work as part of the FSAP was valuable in terms of program design.

ii. Strong Government commitment to the program along with the high quality of officials involved in the implementation was instrumental in the positive outcome. At times Government commitment was reflected in policy decisions that went beyond the Bank's recommendations as in the case of the decision to bring all public sector banks either to the point of sale or to cease their operations.

iii. Some reforms of the financial system do not simply involve the passage of legislation or new regulations, since other legal obstacles may prevent their immediate application or the institutional implementation capacity needs to mature. Slower than expected progress in terms of the bank resolution practices points to the need for greater sensitivity to the legal obstacles such as commercial code and property disposal procedures, involved in this process.

iv. Greater attention to market needs and familiarity with new financial instruments is important to the success of any new initiatives. While the results of the securitization initiatives supported by the Loan have exceeded expectations, the design of the swap mechanism to be used by banks in managing their interest rate risk has been somewhat disappointing. While the latter was not formally part of the loan program and therefore somewhat outside the scope of this evaluation, it is simply observed that the lack of interest by banks can also be attributed to the complexity of design.

v. The Policy Based Guarantee, having benefited from the Government's compliance with the first tranche of the loan, was implemented under an already sound policy platform. The credibility of the earlier actions already accomplished under the program, were instrumental in garnering sufficient investor interest which helped Colombia meet its external financing requirements. In this respect, hybrid loan/guarantee operations should be examined with interest to determine if they provide more "policy leverage" and better sequencing than stand-alone policy guarantee operations.

9. Partner Comments

(a) Borrower/implementing agency.

GOVERNMENT COMMENTS ON THE FSAL PROGRAM

Antecedentes

Dentro de las acciones emprendidas por el Gobierno Nacional para atender la crisis del sector financiero, se destaca la búsqueda del apoyo de la banca multilateral para financiar el costo que implicaba hacer frente esa crisis. Fue así como se contrató el crédito BIRF 7000-CO, en diciembre de 1999.

El mencionado crédito tenía como objetivo minimizar el riesgo sistémico en el sistema financiero colombiano y promover la capacidad de ahorro en el largo plazo y la eficacia del sistema, objetivos que iban en la dirección de apoyar el crecimiento económico del país.

Para alcanzar estos objetivos se previeron reformas en las siguientes áreas:

1. Políticas macroeconómicas consistentes con los objetivos del programa
2. Fortalecimiento del esquema legal, de regulación e institucional del sistema financiero
3. Reestructuración y desmonte de la banca pública
4. Reformas al sistema cooperativo y a la financiación vivienda
5. compatibilizar los programas especiales de financiamiento al sector financiero por parte de FOGAFIN con su papel como entidad aseguradora de depósitos

Los Componentes y sus resultados

<u>Políticas macroeconómicas consistentes con los objetivos del programa</u>

Se cumplieron las metas respecto a la reducción del déficit fiscal, la inflación y la tasa de interés.

El informe de evaluación del préstamo, en cabeza del Banco Mundial, califica el mismo como satisfactorio dada la calidad del plan y su desarrollo, el compromiso del Gobierno y la persistente supervisión bancaria que redundó en resultados exitosos.

En efecto, como resultado de las acciones adelantadas, en el marco de los objetivos del crédito, se logró reducir la inflación a su nivel histórico más bajo, la tasa de interés y el déficit del sector público no financiero, a pesar del difícil entorno económico, político, internacional y de seguridad.

<u>Fortalecimiento del esquema legal, regulatorio e institucional del sistema financiero</u>

Pare evitar la repetición de los problemas por los que atravesó el sector financiero y sentar las bases para el desarrollo sano del sector bancario colombiano el Gobierno impulsó y reglamentó la Ley 510 de 1999 (Reforma Financiera). Con esta reforma se establecieron mecanismos para hacer más eficiente y expedita la resolución de entidades; se establecieron aspectos para fortalecer la regulación y supervisión prudencial; se implementaron esquemas de alerta temprana; se ajustó el régimen de inversiones y operaciones de las entidades financieras, etc.

Igualmente, se fortaleció la vigilancia bancaria y la regulación prudencial, se promovió el desarrollo oportuno de situaciones de insolvencia en las entidades bancarias, se fortaleció institucionalmente a la Superbancaria y al FOGAFIN, entre otros.
Producto de estas y otras medidas se redujo el riesgo sistémico en el sector y se evito la propagación de la crisis financiera.

<u>Reestructuración de la banca pública</u>

El Gobierno puso en marcha un plan que le permitiera disminuir su participación en las entidades financieras de carácter público. En este sentido se tomaron acciones para disolver y liquidar la Caja Agraria y crear una nueva institución sin los vicios del pasado pero que atienda al sector agropecuario y las poblaciones apartadas, dadas las fallas de mercado.

Este fue el componente más desafiante del programa dada la diversidad de instituciones y la complejidad de sus problemas que unidos a obstáculos legales y políticos hacia difícil adelantar estas acciones. No obstante, se lograron importantes aspectos como la liquidación del Banco Central Hipotecario, la fusión de Uconal con Banestado, el marchitamiento y desmonte progresivo de Banestado, la puesta en punto de venta de Bancafé, el saneamiento de Granahorrar, la liquidación de la FES, la reducción de la participación del Estado en fiduciarias públicas y la creación de CISA.

Desafortunadamente, problemas de índole legal impidieron la implementación de la estrategia de reducción de la participación del Estado en los bancos de segundo piso.

<u>Reformas al sistema cooperativo y a la financiación de vivienda</u>

El programa apuntó a racionalizar la actividad de las instituciones cooperativas diferenciándolas entre cooperativas financieras y cooperativas de ahorro y crédito.

A las cooperativas financieras se les sujeto a las normas y supervisión de la Superintendencia Bancaria como cualquier intermediario financiero. En este sentido se aplicaron nuevas reglas de regulación prudencial que llevo a una depuración de este tipo de entidades.

Por otra parte, se creo la Superintendencia de Economía Solidaria y el Fondo de Garantías de las Cooperativas con el objeto de supervisar en forma estricta y otorgarle seguro de depósitos a los ahorradores de las cooperativas de ahorro y crédito.

Estas medidas redundaron en la recuperación del sector cooperativo financiero y en la recuperación de los ahorradores del sector.

El campo de la financiación fue uno de los que más exigió al Gobierno y al Banco Mundial en la búsqueda de soluciones. Vale la pena destacar la ley 546 de 1999 – ley de vivienda- que estableció diferentes criterios y objetivos para regular la financiación de vivienda. Mediante la reglamentación de dicha ley se definieron aspectos como la titularización , el fondo para cubrir el riesgo por el descalce de tasas de interés que presentan las entidades hipotecarias, las condiciones mínimas que deben tener los préstamos hipotecarios, los alivios a deudores, los sistemas de amortización de los créditos hipotecarios, etc.

Las interpretaciones de la Corte Constitucional hicieron más complejo la implementación de medidas en aras de solucionar los problemas relativos a financiación de vivienda, lo cual implico adoptar medidas adicionales por parte del Gobierno Nacional en este campo.

Sobre el Fondo de Estabilización de la Cartera Hipotecaria, diseñado para cubrir el riesgo descalce de tasas de interés que presentan las entidades hipotecarias, consideramos que no ha sido utilizado por los bancos hipotecarios en la medida que las tasas de interés han estado relativamente bajas. En todo caso, no sobra señalar que la cobertura está a disposición de los bancos para que la utilicen en el momento que consideren adecuado.

<u>Apoyo al programa de FOGAFIN para racionalizar el sector financiero</u>

FOGAFIN implementó exitosamente varias medidas tendiente a lograr el fortalecimiento del sector financiero privado, lo cual contribuyó eficazmente a recuperar la confianza en el sistema. En vista del rol importante que FOGAFIN jugaba en la resolución de problemas del sector financiero se delineó claramente los diferentes tipos de actividades del mismo, separando cada área de operación.

Consideraciones Finales

Todos estos resultados positivos se alcanzaron con el apoyo y la colaboración técnica del Banco Mundial y dado el compromiso del Gobierno y las distintas entidades por adelantar las políticas previstas en el programa. Por esta razón, la calificación global de los distintos componentes ha sido calificada por el Banco Mundial como satisfactoria.

El Programa de Ajuste al Sector Financiero fue fundamental para la implementación de diferentes políticas y medidas dirigidas a fortalecer el sistema financiero colombiano.

PRECISIONES Y AJUSTES AL INFORME DE EVALUACIÓN DEL BANCO MUNDIAL

Se sugiere sustituir la palabra CAVS por los BECH porque la definición de CAVs ya no existe legalmente.

Se considera que uno de los factores que incidió en el alza considerable de las tasas de interés no fue el limitado acceso a los mercados internacionales sino que fue el deseo de proteger el esquema de banda cambiaria.

Se debe precisar que sólo se creó una Subdirección (la de Recuperación de Activos) en la Reforma de la Estructura Administrativa de FOGAFIN porque la Subdirección de Operaciones y Financiera se había dividido en dos previamente. Se debe precisar que CISA sólo ha tenido que ver con el manejo de los activos improductivos de los bancos públicos y no exactamente de los activos de las entidades que se encuentran bajo liquidación. Sin embargo, este hecho está mencionado en el numeral 43.

Se debe aclarar que en el caso de los Bancos del Estado y Banco Uconal no fue factible trasladar los activos malos a CISA. Por lo tanto, el BanEstado actual fusionado con el Banco Uconal está administrando esos activos.

No es claro si el significado de "significant portfolio" hace relación a non-perfor ming portfolio".

El camino que está siguiendo FOGAFIN relativo a la liquidación del banco es aclarar los aspectos legales que le permitan sin riesgos tomar al Gobierno tomar la decisión respecto a su liquidación. Por lo tanto no es claro el sentido de la fease "once the outstanding legal claims ...are settled.. porque el tiempo que tomará resolver las controversias jurídicas puede ser de más de 10 años adicionales. Además sería pertinente aclarar que el status de la FES no es cooperativo sino era una fundación que tiene un carácter jurídico diferente.

Granahorrar. Aunque la estrategia señalada fue la que se diseño en un comienzo es posible que el esquema que adopte el Gobierno sufra modificaciones.

Favor corregir las cifras de transferencias son de $182 mil millones en 1999, $215 mil millones en 2000 y $ 184 mil millones en 2001.

COMENTARIOS ADICIONALES

El PIB cayó el 3.4% en 1997 al 0.6% y –4.2% en 1998 y 1999, respectivamente.

Las pérdidas del sistema financiero fueron de $1,9 billones y $2,7 billones en 1998 y 1999. En éste último año, el 75% de dichas pérdidas correspondieron a los bancos públicos.

- Complementar:

  Decretos de Emergencia Económica: Decretos 2330 y 2331 de 1998

- Complementar:

  Considerar que los objetivos generales de la resolución de la crisis financiera fueron:

  Evitar el riesgo sistémico

  Garantizar la confianza en el sistema financiero

  Minimizar el costo fiscal

- Complementar:

  Otras medidas complementarias fueron:

  Acciones estructurales para reducir las tasas de interés y generar liquidez en la economía.

  Generar medidas de apoyo al sector real de la economía en dificultades (Ley 550 de 1999 de Intervención Económica).

  Fortalecimiento del Sistema de Seguro de Depósitos

  Consolidar la reducción sostenida del IPC

- Aclarar:

  Banco Agrario de Colombia

  Para efectos de análisis siempre se ha considerado Banco Uconal y BanEstado como uno sólo.

- Complementar:

  Artículo 30 de la Ley 546 de 1999 mediante el cual la Nación a través de Fogafín garantiza los bonos y títulos hipotecarios VIS subsidiable.

- Complementar:

    Las entidades cooperativas de carácter financiero pasaron a ser vigiladas por la Superintendencia Bancaria de Colombia.

    Aclarar el papel fundamental que jugó la estrategia tomada para Megabanco en el sector cooperativo.

- Complementar:

    Corregir el dato de inflación en 1998 del 16.7% y no 20.4%.

    El cuadro de indicadores se puede complementar con la siguiente información:

	1997	1998	1999	2000	2001	2002 est
GDP	3.4%	0.6%	-4.2%	2.7%	1.4%	1.6%
Inflación	17.7%	16.7%	9.2%	8.7%	7.6%	6.0%

- Complementar:

    En efecto, conforme con las directrices establecidas por la Superintendencia Bancaria de Colombia, los recursos que administra Fogafín están plenamente identificados diferentes fondos independientes del de seguro de depósitos.

- Complementar:

    Con respecto a la liquidación del BCH, aclarar que se esta en la etapa de la conmutación del pasivo pensional y la venta de activos remantes.

- Complementar:

    Se espera que la vinculación de capital privado vía venta o capitalización del Bancafé se culmine en el 2003, para lo cual se requiere el traslado del pasivo pensional al FOPEP.

- Complementar:

    Aclarar que las finanzas del Fondo y el apoyo al sector bancario público fue posible también, mediante la emisión de Bonos Banca Pública por $4,95 billones, los cuales serán servidos con vigencias futuras del Presupuesto General de la Nación.

(b) Cofinanciers:

Not available.

(c) Other partners (NGOs/private sector):

Not applicable.

10. Additional Information

Annex 1. Key Performance Indicators/Log Frame Matrix

Outcome/Impact Indicators:

Indicator Based on MOP Projections	Actual/Latest Estimate
I Maintain a satisfactory Macroeconomic Framework	Government's macroeconomic program on target; inflation and interest rates down significantly, contributing to a more stable financial system.
II. Strengthen the Legal, Regulatory and Institutional Framework of the Financial System	Amended Law passed in 1999: enhances ability of regulators to act quickly and take corrective measures to prevent systemic problems and support sustainable growth.
	Capital adequacy ratios of the banking system increased significantly, thus improving the system's ability to withstand economic shocks and downturns.
	SBC implementation of intensively supervised "institutional recovery programs" contributed to reduced incidence of bank failures and avoidance of systemic crisis.
	Greater depth of regulatory norms and increased effectiveness in their implementation and in supervision efforts by SBC and FOGAFIN which has reduced systemic risk. Market based burden sharing mechanisms implemented to absorb risks via sale of assets.
III Restructuring and Resolution of State-Owned Banks	
	New *Banco Agrario* has improved the quality of the loan portfolio of public sector banks.
	Closure and eventual sale of publicly owned banks has substantially reduced the presence of the Government in the financial sector and increased the efficiency of the system and prospects for sustainable growth.
	Restructuring of State banks and second-tier banks has contributed to greater efficiency in financial intermediation by passing on greater participation to private sector banks.
IV. Reform of the Cooperatives System	
	By applying same rules to financial cooperatives as those applied to other intermediaries, inherent

	structural weakness of this sub-sector has been largely diminished. The current seven financial cooperatives are in the process of diversifying their business into other asset / liability products in line with their competitive strengths.
V. Rationalization of Special Programs Implemented by FOGAFIN	FOGAFIN has been able to increase its efficiency as it has increased the number of financial intermediaries participating in special programs without detracting from its basic deposit insurance functions. The special programs have provided temporary support while financial institutions become more strongly capitalized.

Output Indicators:

Indicator Based on MOP Projections	Actual/Latest Estimate
I Maintain a satisfactory Macroeconomic Framework	Government's macroeconomic program on target; fiscal deficit reduced; inflation and interest rates down significantly.
II. A. passage of Amended Financial Institution Law	Amended Law passed in 1999: enhances ability to regulators to act quickly to prevent systemic problems. Regulatory and supervisory mechanisms implemented to execute Law.
II. A. (i) appropriate prudential rules	Risk-based capital standards as well as more stringent loan classification and loss provisioning rules implemented. Both contributed to lower systemic risk
II A. (ii) system of prompt corrective actions	Explicit criteria established for the so-called "recovery program" for troubled banks to be monitored by SBC. This approach lowers the risk of bank failures.
II A. (iii) market-based bank resolution devices	Capitalization program administered by FOGAFIN assists troubled, but viable, banks early on, and liquidation or loan portfolio sale process improved.
II A. (iv) FOGAFIN financing to be explicitly conditioned	Banks that participate in a capitalization program are required to implement a recovery program. This will improve the efficiency of the system and help to promptly liquidate insolvent institutions.
II. A (v) clear separations of FOGAFIN's various functions	Financial control mechanisms in place to ensure that all funds are managed separately, thus improving the

	efficiency and safeguards to depositors, under the regulatory function.
II. B Institutional strengthening plan in FOGAFIN.	Restructuring plan recommended by McKinsey and Co.was implemented early on contributing to increased efficiency and internal capacity strengthening of the agency.
II.C Institutional strengthening plan in SBC.	Strengthening plan implemented with consequent efficiency gains and development of sophisticated risk monitoring systems to track the condition of financial institutions.
III. A. Dissolved Caja Agraria and make Banco Agrario operational	Closure of *Caja Agraria* and establishment of *Banco Agrario* should contribute to enhanced efficiency of financial intermediation by the public sector.
III. B. Investment bank hired to pursue privatization of 5 state-owned banks	Investment banks hired with the following outcomes: BCH and *BanEstado* have ceased operations and their assets along with commensurate liabilities transferred to other financial institutions; FES was also liquidated; sale of *Granahorrar* not feasible and will be dismantled; and sale of *Bancafe* delayed due to unfavorable market conditions. Government is now seeking a strategic partner to buy 51 percent of the bank. When completed, this will have noticeably reduced the involvement of the Government in the financial system.
III. C. Complete study to rationalize second-tier state-owned institutions	Study completed and recommendations called for consolidation of existing entities, while removing market-distorting practices such as simultaneous 1st tier lending. Implementation of this component should result in greater efficiency in financial intermediation.
IV. A Adoption by SBC of proper rules for financial cooperatives	New rules were implemented and number of financial cooperatives sharply reduced from a potential of 54 entities to about 7. Application of same standards as other financial intermediaries should contribute to lower risks of systemic problems.
V. Steps taken to ensure the separation of FOGAFIN's special programs	FOGAFIN has adopted internal control mechanisms to ensure appropriate separation of its various activities. This will help the entity focus its attention more effectively on each initiative, and thus contribute to greater effectiveness in managing financial sector problems, while protecting deposit insurance funds.

Annex 2. Project Costs and Financing

Not Applicable.

Annex 3. Economic Costs and Benefits

Not Applicable.

Annex 4. Bank Inputs

(a) Missions:

Stage of Project Cycle	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.)		Performance Rating	
Month/Year	Count	Specialty	Implementation Progress	Development Objective
Identification/Preparation				
1 / 1999	1	TM/Financial Sector/Economist		
3 / 1999	3	TM/Financial Sector/Economist Banking Housing Finance		
5 / 1999	5	Banking Restructuring TM/Financial Sector Banking Supervision Housing Finance Securities Markets		
Appraisal/Negotiation				
10 / 1999	4	TM/Financial Sector / Economist Treasury Operations Financial Management Legal		
Supervision				
12 / 1999	1	TM/Financial Sector / Economist	S	S
5 / 2000	5	Banking Housing Finance Capital Markets TM/Financial Sector / Economist	S	S
12 / 2000	4	TM/Financial Sector / Economist Housing Finance Banking Restructuring Banking Supervision	HS	HS
6 / 2001	3	TM/Financial Sector / Economist Banking Housing Finance	HS	HS
ICR				
11 / 2002	2	Banking/Economist Financial Sector Specialist	HS	S

(b) Staff:

Stage of Project Cycle	Actual/Latest Estimate	
	No. Staff weeks	US$ ('000)
Identification/Preparation	17.0	98,655
Appraisal/Negotiation	16.0	72,197
Supervision	20.6	149,659
ICR	6.0	21,700
Total	59.6	342,211

Annex 5. Ratings for Achievement of Objectives/Outputs of Components

(H=High, SU=Substantial, M=Modest, N=Negligible, NA=Not Applicable)

	Rating
☐ *Macro policies*	○ *H* ● *SU* ○ *M* ○ *N* ○ *NA*
☐ *Sector Policies*	● *H* ○ *SU* ○ *M* ○ *N* ○ *NA*
☐ *Physical*	○ *H* ○ *SU* ○ *M* ○ *N* ● *NA*
☐ *Financial*	● *H* ○ *SU* ○ *M* ○ *N* ○ *NA*
☐ *Institutional Development*	● *H* ○ *SU* ○ *M* ○ *N* ○ *NA*
☐ *Environmental*	○ *H* ○ *SU* ○ *M* ○ *N* ● *NA*
Social	
☐ *Poverty Reduction*	○ *H* ○ *SU* ○ *M* ○ *N* ● *NA*
☐ *Gender*	○ *H* ○ *SU* ○ *M* ○ *N* ● *NA*
☐ *Other (Please specify)*	○ *H* ○ *SU* ○ *M* ○ *N* ● *NA*
☐ *Private sector development*	○ *H* ● *SU* ○ *M* ○ *N* ○ *NA*
☐ *Public sector management*	○ *H* ○ *SU* ● *M* ○ *N* ○ *NA*
☐ *Other (Please specify)*	○ *H* ○ *SU* ○ *M* ○ *N* ○ *NA*

Annex 6. Ratings of Bank and Borrower Performance

(HS=Highly Satisfactory, S=Satisfactory, U=Unsatisfactory, HU=Highly Unsatisfactory)

6.1 Bank performance	*Rating*
☒ *Lending*	○ *HS* ● *S* ○ *U* ○ *HU*
☒ *Supervision*	● *HS* ○ *S* ○ *U* ○ *HU*
☒ *Overall*	○ *HS* ● *S* ○ *U* ○ *HU*

6.2 Borrower performance	*Rating*
☒ *Preparation*	○ *HS* ● *S* ○ *U* ○ *HU*
☒ *Government implementation performance*	● *HS* ○ *S* ○ *U* ○ *HU*
☒ *Implementation agency performance*	● *HS* ○ *S* ○ *U* ○ *HU*
☒ *Overall*	● *HS* ○ *S* ○ *U* ○ *HU*

Annex 7. List of Supporting Documents

Ministry of Finance, Diagnostico Sobre la Banca de Segundo Piso en Colombia y Evaluación de Alternativas, October 1998.

World Bank and IMF, Colombia: FSAP Draft Report, August 1999.

FOGAFIN, Estrategia Para la Solución de los Problemas del Sector Financiero, September 21, 1999.

FOGAFIN, Impacto Fiscal de las Medidas del Proyecto de Ley de Vivienda, October 1999.

Banking Superintendency, Las Cooperativas Financieras y su Entorno, September 1999.

Superintendency of Banks, Programa de Fortalecimiento de la Superintendencia Bancana, 1999.

Memorandum of the President, Report No. P 7337 CO, October 20, 1999

World Bank, Housing Finance Reform and Mortgage Instruments in Colombia, report, October 30, 2002.

World Bank Policy Guarantee for US$ 1.0 Billion Amortizing Notes, Ex-Post Evaluation of the Guaranteed Issue, Draft Report by the Bank, 2001

FOGAFIN, Annual Reports, 1998, 1999, 2000, 2001

Superintendency of Banks, Annual Reports, 1998, 1999, 2000, 2001.

InterAmerican Development Bank, Informe de Terminación de Proyecto, 2001.

IMAGING

Report No.: 25259
Type: ICR