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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED LOAN

IN THE AMOUNT OF US $150 MILLION

FOR A PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT OPERATION

TO THE

REPUBLIC OF COLOMBIA

April 3, 2003

Finance, Private Sector and Infrastructure Department
Country Department for Colombia and Mexico
Latin America and the Caribbean Regional Office

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Currency And Exchange Rates
(As of March 31, 2003)

Currency Unit = Colombian Peso
US$1.00 = C$ 2,958.75

Fiscal Year
January 1 – December 31

Abbreviations and Acronyms

AML/CTF	Anti-money laundering / Countering of terrorist financing
BANCAFE	Banco Cafetero (Bank serving the Coffee Grower's Region)
BANCOLDEX	Banco de Comercio Exterior de Colombia (State Export Bank)
BECH	Bancos Especializados en Crédito Hipotecario (Mortgage Banks)
BR	Banco de la República (Central Bank of Colombia)
CAMEL	Capital/Assets/Management/Earnings/Liquidity
CAV	Corporación de Ahorro y Vivienda (Savings & Loan Banks)
CISA	Central de Inversiones, S.A. (Government Asset Management Agency)
CONPES	Consejo Nacional de Política Económica y Social (Economic Policy Council)
DANE	Departamento Administrativo Nacional de Estadística (Statistics Agency)
DGCP	Dirección General de Crédito Público (Public Debt Office of MoF)
DIAN	Dirección de Impuestos y Aduanas Nacional (Tax and Customs Agency)
DTF	Depósitos a Término Fijo (Interest rate on time deposits)
DTN	Dirección del Tesoro Nacional (National Treasury in Ministry of Finance)
EMBI	Emerging Markets Bond Index
FEN	Financiera Energética Nacional (Government Energy Sector Bank)
FINAGRO	Fondo para Financiamiento del Sector Agropecuario (Agro Sector Bank)
FINDETER	Financiera de Desarrollo Territorial (Municipal Financing Bank)
FIs	Financial Institutions (supervised by the Banking Superintendency)
FOGAFIN	Fondo de Garantías de Instituciones Financieras (Deposit Insurance Agency)
FRECH	Fondo de Reserva para la Estabilización de la Cartera Hipotecaria
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
IFI	Instituto de Fomento Industrial (Industrial Development Bank)
M2	Currency in circulation, demand deposits and time deposits
MBS	Mortgage Backed Securities
MoF	Ministry of Finance
PDR	Problem Debt Restructuring
RP/REPO	Repurchase Market / Repurchase Operation
SARC	Sistema de Administración Riesgos de Crédito (Credit Risk Mgmt. System)
SB	Superintendencia Bancaria (Superintendency of Banks)
SEARS	Sistema Especial de Análisis de Riesgos de Seguro (Insurance Risk Mgmt. Sys.)
SEN	Sistema Electrónico de Negociación (Electronic Trading System - Gov't Debt)
SV	Superintendencia de Valores (Securities Superintendency)
TES	Treasury Bills/Notes
UIAF	Unidad de Inteligencia y Análisis Financiero (AML Analysis Unit)
UPAC	Unidad de Poder Adquisitivo Constante (Mortgage Price Index)
UVR	Unidad de Valor Real (Index based on real value of mortgages)
VAR	Value at Risk
VIS	Vivienda de Interés Social (Social Priority Housing)

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REPUBLIC OF COLOMBIA

PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

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REPUBLIC OF COLOMBIA

PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

PROGRAM AND LOAN SUMMARY

Borrower: The Republic of Colombia

Implementing Agency: Ministry of Finance

Objective:

The objective of the loan is to complete the clean up of the banking system as a result of the 1999-2001 crisis and to strengthen the government's capacity to manage and mitigate weaknesses in the financial system. The project also aims to strengthen and diversify the participation of the housing mortgage market including improved access to finance for the micro sector, as well strengthening non bank financial services and securities institutions in the financial system.

Description:

Banking Sector. A key aspect of the proposed program is the design of a multi pronged effort to first dispose of the financial system's residual loan assets (or collateral) remaining from the interventions during the earlier crisis, by developing more agile and modern financial instruments and fiduciary arrangements to package and sell loan assets. As part of this effort, the remaining intervened banks are expected to be divested and one of the largest second tier problem banks will be wound down. Prudential regulations and supervision would be strengthened to incorporate corporate governance rules and development of a graduated sanctions regime to ensure corrective actions.

Housing Finance and Non Banks: As part of mortgage market reform, the program will address the micro credit sector and promote further credit access through the development of credit instruments targeted to the micro housing sector. The securitization industry will be further developed to support bank asset sales, to provide more liquidity to the mortgage industry, and to help develop the capital markets. A reform of the capital requirements and risk management regulations applicable to insurance companies, trusts, and pension funds, will be implemented to ensure the solvency of these institutions.

Capital Markets and Government Securities. A reform of the entire securities legislation will be conducted as part of the program's second phase, to promote a more agile development of the local capital market. This will involve reforming corporate governance and disclosure standards as well as fit-and-proper criteria for securities industry participants. A streamlining and adjusting of the benchmarks and exposure risks of the government

debt market will take place as well as enabling the creation of a reference yield curve for the public and private bond markets.

Poverty Aspects:

The program's objective as linked to social protection, is to strengthen and improve the financial sector's solvency and profitability to serve as a catalyst for private sector led growth. The implementation of reforms in bank resolution mechanisms and reforms of the deposit insurance scheme will protect the weakest depositors with the least economic assets, and assure prompt and full repayment of their funds in the event of bank failures. The regulatory reforms under the financial system law generate strong incentives and financial mechanisms to channel private banking credit to the micro and rural credit housing markets. The loan proceeds will help mitigate the impact from the government's tight fiscal policy, helping to maintain social expenditures.

Benefits:

The reformed legal framework would significantly upgrade and facilitate the regulation, corporate governance, and risk management of the financial system. It would increase the autonomy of the supervisory body and upgrade the mechanisms available for prompt corrective action, and resolution of intervened or insolvent banks to minimize potential drains on the public budget. The rationalization and consolidation of the state owned banking sector will also reduce fiscal exposure.

The new framework will open up the financial market, under tight prudential rules, to allow diversification and improvement of products in the housing finance and mortgage market sector, including funding instruments for the micro credit sector, as well as in the capital markets, thus diversifying financial risks into other sub-sectors with capacity to raise financing and liquidity.

Risks:

The main risks to the reform program pertain to the possibility of adverse economic shocks which might be exogenously or regionally generated and which would set back the growth prospects for Colombia and thus compromise the long term health of the financial system which is just coming out of a tough period following the 1999 crisis. A low or negative growth scenario for the next two years would not only threaten overall welfare, but could also reverse the gains in banking system health and generate the need for new contingency plans to rescue vulnerable institutions. Another risk pertains to the fiscal risk of over exposure, particularly to the internal capital market as well as the risk that international financial market access will remain difficult for a prolonged period. Finally, a key risk is the potential for the internal conflict to deteriorate, causing additional fiscal stress and slowing down or braking progress on the financial sector reform.

Loan Amount:	US $150 million, for the first programmatic loan, to be disbursed upon meeting Board approval conditions.
Terms:	LIBOR-based US Dollar Fixed Spread Loan with a final maturity in 2014 with a bullet repayment.
Commitment Charge:	0.85% percent on undisbursed loan balances (first 4 years). During FY-2003, the annually approved 0.50% waiver of the charge, was in effect.
Front-end Fee:	1 percent of the loan amount payable out of loan proceeds.
Schedule of Disbursements:	First loan to be disbursed upon Board Approval following effectiveness. Conditionality met prior to Board presentation.
Project Identification No.:	PE-P078869-LEN-BB

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
PROGRAM DOCUMENT
ON A PROPOSED
PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN
TO THE REPUBLIC OF COLOMBIA

1. This program document proposes a one-tranche Financial Sector Adjustment Loan as part of a two phase Programmatic Financial Sector Operation to the Republic of Colombia. The first loan would amount to US$150 million to support the reform of the financial system through a reform framework for banking legislation, strengthening of bank and securities supervision, resolution of banks using market mechanisms, closure, sale or merger of government owned financial institutions, as well as a legislative and institutional strengthening program to reform the securities market, non-bank financial services, and the government debt and money markets. The program would be implemented by the Ministry of Finance with support from the Superintendency of Banks, the Deposit Insurance Agency (FOGAFIN), the Superintendency of Securities, the Public Debt Office, the Central Bank and the National Treasury. The first Loan would be LIBOR-based, US Dollar denominated Fixed Spread Loan, with a grace period of eleven years and a final maturity of eleven years with a bullet repayment of principal.

PART I. RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

A. Recent Economic Developments

2. Colombia's vulnerability to external shocks has risen in recent months as a result of several factors: increased violence domestically and uncertainty as regards the future path of the internal conflict; the sharp deterioration in sovereign debt spreads; the recent worsening of market sentiment towards Latin America; problems in Venezuela, the second largest market for Colombia's non-traditional exports; and an uncertain outlook for the US economy, Colombia's main trading partner. That said, Colombia is relatively well-equipped to deal with moderate external shocks, given its floating exchange rate, falling inflation, adequate international reserves (US$ 10. 8 billion), as well as the implementation of new additional fiscal adjustments and reforms.

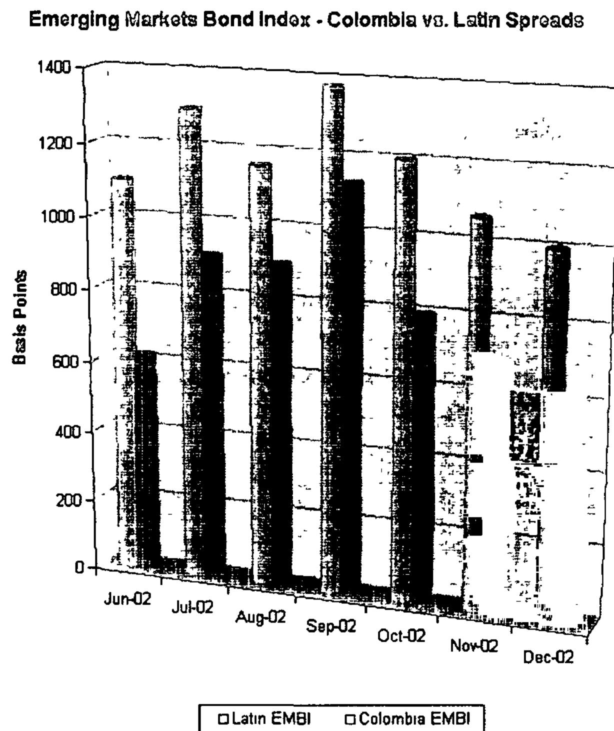
3. Colombia's sovereign spreads and currency had, until recently, been relatively unaffected by regional events, partly the result of the pre-financing by the government of more than three quarters of its external market financing needs for 2002. Pre-financing was undertaken in 2001 in order to avoid accessing the markets in the run-up to the presidential election. Colombian bond spreads fell throughout 2001 and in early 2002, but increased somewhat in April after Colombia's sovereign rating was downgraded by Fitch and its outlook changed to negative by Moody's, both citing growing public debt and an uncertain outlook for reforms and fiscal results. Despite this, in June 2002 the government obtained fresh funds in the international bond market for US$195 million issued at a 10.5% coupon interest rate, and an additional US$500 million in December 2002 at a 10.75% rate.

4. Colombia's macroeconomic performance is expected to continue improving in the next two to three years, but it will take longer before the country is able to achieve its full economic potential. Following a mild recovery of economic activity in 2002, GDP growth is expected to accelerate to about 2.5 percent in 2003 mainly due to a recovery of the export sector and slightly

better prospects for aggregate private investment. Growth is expected to rise in 2004 to levels around 3 percent, accelerating to 3.5 percent by 2006.

5. **External Environment.** Exports will be aided by a projected recovery of international trade growth and prices of some of Colombia's key export products. A shift in trade patterns is also expected, as the share of trade with neighboring countries will likely shrink dramatically due to the weak economic prospects of some regional partners, especially Venezuela where recent policies may imply an almost total cut-off of Colombia's exports to that country thus having potentially serious adverse balance of payment effects. The prospective economic recovery in the U.S. and Europe suggests that Colombian exporters will shift their attention to these regions, with the impact of economic recovery in those markets further amplified by a possible weakening of the US dollar relative to other major currencies, particularly the Euro. Colombia's exchange rate is projected to depreciate mildly in real terms over the next three years, as continued low domestic inflation and a flexible exchange rate policy facilitate a smooth adjustment of the tradable sector. In this connection, inflation is expected to continue on a downward path and stabilize at levels close to 4 percent by 2005 (from 6 percent in 2002).

6. **Financial and Monetary Developments.** The Colombian peso depreciated by nearly 20 percent in nominal terms in the third quarter of the year, at the same time that Colombia's EMBI spread nearly doubled to 1100 basis points. The fall in Colombian bond prices was precipitated by negative alerts posted by the rating agencies as fiscal slippages became evident amid effects of intensified regional contagion. Increased risk perception also reduced the liquidity of the domestic public debt particularly at the long end, with the yield on ten year government notes rising by 5 percentage points to 17.5 percent. The stress in financial markets eased notably in October following indications of increased financing from the international financial institutions as well as a more general tightening of the risk premia in emerging markets in the region. By the second half of November, the bond spread had narrowed to below 700 bps.



7. A systemic banking collapse had been averted in 1999, through the officialization of affected banks and a consolidation process that drastically reduced the number of players in the market; however, the fiscal liability arising from rescuing borrowers, depositors, and bankers was large, and is so far estimated at about 4 percent of GDP (including non cash contingent liabilities of the Government and additional resources raised via the financial transactions tax). A final accounting of costs will also depend on how much of the losses from non-performing loans of public sector banks are recovered via the ongoing disposition of the foreclosed assets.

8. There are still significant weaknesses in the housing finance sector where the non-performing loan portfolios continue to loom large (especially in the state controlled entities) and risks associated with asset-liability mismatches have not yet been fully addressed. Reforms are also needed to improve the operation of public debt management, address critical governance and regulatory issues related to entities participating in the capital and debt markets, consolidation of state controlled second-tier banking entities, and regulation for bank resolution, bad-asset disposition and the insurance sector. Therefore, building on the financial sector reforms put in place during 1999-01, a second round of financial sector reforms will need to be implemented, while minimizing any further fiscal costs or interruptions in the flow of bank lending to the private sector.

9. Banking as well as insurance and pension reforms also go hand in hand with a strategy to create a deeper, more liquid capital market. Much activity is underway: the three stock exchanges have already been integrated and merged; a proposed draft capital market framework law that would reduce obstacles for private securities issuance is currently in preparation; a new private mortgage securitization firm is now operating; market-making has been institutionalized for government bonds; and, an almost complete range of Treasury bill maturities are now available.

10. Finally, a healthy and stable development of the domestic financial sector requires strengthening the legal and regulatory framework applicable to financial institutions, including the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime. The Ministry of Finance and Banking Superintendency have strengthened the AML/CTF system over the last two years, including the establishment of a monitoring unit to detect money laundering and white collar crime.

B. Economic Prospects and Financing Requirements

11. While the current policy framework is expected to provide for a solid adjustment of the external sector, the key risk to the country's macroeconomic stability remains the large fiscal deficit and the high burden of public debt. Assuming a full implementation of the macroeconomic reform package, the overall public sector deficit is projected to fall from about 4 percent of GDP in 2002, to between 2.5 - 3.0 percent in 2003, and between 2.0 - 2.5 percent in 2004 and 2005. However, due to the lag in the fiscal adjustment process as well as the relatively conservative economic growth prospects projected for the country, on a net basis total public debt is still projected to continue rising (although at diminishing rates) before stabilizing at levels close to 50 percent of GDP by 2006. Achieving these goals for the overall public sector and thus macroeconomic stability on a sustainable basis will require strong and deep adjustment at the level of the central government, especially on the expenditure side, for which the authorities have agreed on a strategy in coordination with the IMF. In January 2003, an IMF Stand By Arrangement (SBA) was approved for a two year period. The SBA also includes structural

banking sector benchmarks for privatizing Bancafé and eventually divesting Granahorrar, two State banks.

12. The Colombian economy has since 1998, been growing at an average rate of close to zero cumulatively during the last four years. The current account deficit in 2002 is estimated at $2.2 billion, and is projected at $2.4 billion for 2003 and $2.3 billion for 2004. For 2003 and 2004, the presently identified financing requirement in the capital account, is estimated at $2.0 billion and $1.7 billion for both years, respectively (see table below), excluding the changes in international reserves across both years.

Colombia: External Financing Requirements ($US millions)

	2002 (est.)	2003 (proj.)	2004 (proj.)	2005 (proj.)
Current Account Balance	(2,259)	(2,413)	(2,349)	(2,201)
Capital Account Financing, net:				
i. Foreign Direct Investment	2,333	2,391	2,475	2,561
ii. Loans:				
o/w Official/Multilateral	442	1,655	2,309	1,396
o/w Private	(448)	(1,090)	(1,729)	(1,107)
iii. Other Capital	(31)	(96)	(99)	(74)
Int. Reserves [(-) = increase]	(37)	(446)	(607)	(576)

Source: World Bank Country Assistance Strategy, Annex B6

13. While the current account deficit is not expected to grow, financing from the capital account, particularly from private lenders, is expected to reflect negative flows on the order between -$1.0 billion to -$1.5 billion, for the foreseeable future. Therefore, balance of payments financing requirements will rely primarily on multilateral and official financing to meet the gap which, including other factors, will require on average, $2 billion annually in the next two years.

PART II. FINANCIAL SECTOR CONTEXT AND THE REFORM PROGRAM

A. Overview

14. At the start of the 1998 banking crisis, the government, recognizing the seriousness of the issues facing some segments of the financial sector, the Government introduced in November 1998, through an Emergency Executive Decree, 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 cooperative system. 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.

15. The objectives of the program supported by the earlier loan were to minimize systemic risk in the Colombian financial system and to promote the longer-term capacity and efficiency of the system in restoring 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 that operation were a macro-economic program that enabled the stabilization and significant reductions in real interest rates, combined with financial sector reforms to ensure a timely and effective implementation of prudential rules and supervision of financial institutions, including preventive measures, case-by-case resolution actions, consolidation of different types of financial intermediation under one institution, and a restructuring of public banks. The operation was viewed by the Government as an important complement to the Economic Emergency Measures adopted in 1998.

16. The government's strategy with respect to the state-owned banks was meant to isolate them from the rest of the financial system in order to restructure or sell them under controlled conditions while avoiding an additional factor of potential contagion to the already weak private banks. Public banks were formally "officialized," meaning that the management oversight and ownership stake were taken over directly by FOGAFIN with a view to clean up the balance sheets, recapitalize the banks, and sell them or liquidate them. The *Caja Agraria*, a rural finance bank, was closed and a new *Banco Agrario* created out of a Leasing Company (*Colvalores*) which was part of the *Banco de Desarrollo Empresarial*; following a reform in the statutory mandate of the institution. Although the remaining banks could have been easily sold in one or two years if economic and market conditions were favorable, the potential further deterioration of the loan portfolio under less favorable conditions and the operating costs of keeping troubled banks open, created some risks. Moreover, for banks that had been experiencing severe management difficulties and weak control systems (often the case for public banks), it was particularly difficult to redress ingrained management habits and instill a new governance culture.

Box 1: Lessons from the 1999/2000 FSAL Loan and the First Financial Sector Reforms

The context in which the prior FY00 FSAL reforms took place, reflected a situation of crisis prevention, avoidance of contagion across the banking sector, and assuring the stability of the financial system. In this light, the measures taken were thoughtful and essentially contained three key strategic tools: (i) intervening, managing and/or providing liquidity and capital support to weak financial institutions, (ii) raising the capital and solvency requirements to force all institutions to build up stronger balance sheets to handle impending risks, and (iii) implementing early corrective actions as defined by the Banking Superintendency to reverse adverse trends in individual institutions before they reached insolvency.

Taken together, the measures were comprehensive and holistic in their approach. However, the existing financial "technology" as well as the limitations in the bank resolution policy framework, later revealed some shortfalls which had not been anticipated, in particular:

(a) For those intervened banks or officialized public banks taken over by FOGAFIN, the asset sale and liquidation process was lengthy, in part due to legally specified time periods endorsed judicially under the Commercial Code which is not governed by the Banking Law. Since this phase of the unwinding of banks constituted the last phase in a process preceded by attempts to sell a bank or a part of its loan portfolio, the issue of final liquidation of collateral and potential judicial delays had not been addressed. This therefore, resulted in the State holding on to such assets for longer periods than anticipated, following the end of the crisis period.

(b) As part of the banking resolution process, the reform permitted the option of transferring viable assets of intervened banks, matched by deposits, to other banks willing to purchase or take over such obligations. The procedure required the concurrence of the ceding bank's depositors and was not fully clear regarding the hierarchy of the bank's creditors, which made it more difficult to transfer deposits with matching assets without taking into account other bank liabilities or obligations. In retrospect, the concurrence of the ceding bank's depositors and other parties while meant to protect legal rights, was not all that practical and made the process of balance sheet transfers more difficult and drawn out. Nevertheless, the procedures were successfully implemented though their frequency and speed might have increased substantially without the legal obstacles.

(c) Even with the successful purchase of assets by healthy banks, along with the assumption of matching deposit liabilities, acquiring banks needed to carefully evaluate the loan portfolios they were purchasing to verify their stated quality. While FOGAFIN did in some instances provide credit enhancement guarantees or outright bonds in order to share the risks of these transferred portfolios, this meant that the State began assuming more contingent liabilities. The existence of securitization mechanisms (which were not fully developed until later when housing finance and capital market norms began to be defined for that purpose) could have avoided the assumption of risk sharing obligations by the State. This is because under securitization procedures, the portfolio assets would be held by a trust at a multiple of the face value of the securitized bonds issued by the trust, thus they would have provided a more optimal 'market based' comfort mechanism for the acquiring banks. However, under near crisis conditions, the development of innovative financial instruments was not of immediate priority and the banking law was not explicit enough to allow optimal use of these instruments along with asset/liability carve-out mechanisms.

While many of the above procedures were indeed envisioned under the 1999/2000 reform, the specification of their implementation mechanisms and the institutional/market infrastructure were not yet sufficiently developed to provide the government with the additional instrumentalities for handling troubled banks. However, despite these initial limitations, the government, through FOGAFIN's management of insolvent institutions and its asset management agency (CISA), was able to achieve substantial progress in the gradual sale and reduction of the assets of those banks. The further development and implementation of the new procedures should provide the government added flexibility in the resolution and divestment of the remaining officialized banks such as Bancafé, Granharrorar, as well as IFI, the second tier industrial development bank.

B. The Banking System

Background

17. Total assets of the Colombian financial system amount to Col$ 159 trillion or approximately US$ 55 billion. The structure and composition of the Colombian financial system is shown below.

Table 1: Colombia - Structure of the Financial Sector
Financial Intermediary Assets
(As of December 31, 2002, in Col$ billions)

	Banks and Deposit Institutions	Corporate Financing Co's.	Ordinary Finance Companies	Finance Leasing Companies	Pension Funds	Insurance Industry	Trust Co's.	Total
Local	47,623	6,694	1,072	2,121	11,724	4,230	22,404	95,868
Foreign	14,256	--	604	81	9,176	3,044	10,780	37,941
State	14,989	1,730	487	106	--	957	10,475	28,744
Total	76,868	8,424	2,163	2,308	20,900	8,231	43,659	162,553
as % of GDP	39%	4%	1%	1%	10%	4%	22%	82%

Source Superintendency of Banks
Note: Total asset figures may be overestimated as financial institutions may hold as assets reflecting the liabilities of other institutions

18. During the 1998-2001 crisis, the financial system underwent some consolidation as credit institutions, particularly mortgage banks were closed, as well as other commercial banks and finance companies. To-date, the financial system has 18 fewer commercial banks (including the ex savings & loans) than it had towards the end of 1998 at the onset of the crisis.

Restructuring of the Banking System

19. After the banking restructuring process during 1999-2001, fewer risks remain with respect to government support of private banks. However, though the experience has been generally favorable, if adverse economic conditions persist and additional banks are not to repay the capitalization credit lines to FOGAFIN, then the State would need to effectively take on the share ownership which was meant to be financed temporarily by FOGAFIN's credit line.

20. For the state-owned banks, the process has been somewhat arduous: more than three years after initial intervention, the final resolution status of some of these is still being worked on, and as the time draws out, the more costly option of outright liquidation looms larger. While the government has successfully been able to gradually reduce and sell off the balance sheets and physical infrastructure of these banks, its investment in this process may need to continue for some time to achieve its end target of privatization or extinction.

21. Table 2 shows the support of FOGAFIN's capitalization program to restore technical solvency of state-owned banks following the intervention and officialization of these banks.

Table 2. Capitalization Support Provided to State-Owned Banks, 1998–2001

Bank	Amount (Col$ billions)
BCH [1]	1,546
Banestado	1,240
Bancafé [2]	1,660
Granahorrar	689
IFI	700
Banco Agrario	150
FES	45
Total	6,030
as % of GDP	3 6%

1. Includes CISA managed assets of BCH.
2. Includes CISA managed assets of Bancafé.
Source: FOGAFIN

Outcomes and Next Steps

22. Thus, it should be pointed out that the government's rapid response and policy approach has been instrumental in averting a systemic financial collapse given the macroeconomic, regional, and global environment. The prompt introduction of a new legal framework for banking capital adequacy, portfolio concentration, and consolidated supervision of financial groups was critical for early diagnosis of the problems. At the onset of the crisis, the establishment of progressively stringent prompt corrective actions for banks facing possible insolvency prevented what might have been fiscal outlays in multiples of what was actually disbursed. The fast implementation of bank capitalization schemes coupled with incentives for risk sharing by owners and more modern procedures for the prompt exit or merger of weak banks in the system was crucial to avoid the proliferation of "zombie" institutions that would have only postponed more serious problems, raising the overall cost of the crisis. Therefore, the government's record in tackling this precarious situation was commendable. However, final resolution and stability of the sector is not assured, and certain risks remain. Some of the key gaps requiring attention so as to permit the orderly conclusion of the processes initiated, *include*:

23. Improvements and increased flexibility in banking resolution measures used to restructure or dispose of weak banks using market agents and instruments. While the prior reforms of the banking law alluded to such mechanisms, the good bank/bad bank approach facilitated by securitizations of portfolios held in trust, was not used given the lack of a firm legal framework requiring such procedures for the resolution of banks. To avoid the languishing of financial institutions under the State's umbrella, if privatizations do not materialize, increased incentives such as auctioned loan portfolio securitizations should be applied, to allow a more prompt carving out of good assets with matching deposits from intervened institutions.

24. *Reducing and Extinguishing Potential Fiscal Liabilities*: To improve the prompt privatization or liquidation of financial institutions considered insolvent, and to wind down weak institutions that have no earnings prospects while compensating depositors, the government has considered additional options for the liquidation or asset sale procedures using a multibank portfolio approach managed competitively. Time-bound performance measures and compensation fees should be applied, with rotation of liquidators to provide incentives for achieving maximum returns in stipulated time periods. Time-bound limits for the disposition (sale or liquidation) of intervened banks could be set, particularly for banks where investments have already been made in recapitalization and improvement of their financial condition. An a priori assessment of market demand is also crucial.

25. *Strengthening the Early Corrective Action Regime:* While banking prudential regulations are strict and include additional provisions for market risks in conformance with Basle standards, completion of these best practices will include the implementation of a matrix of prompt corrective actions associated with a schedule of sanctions and penalties, based on non compliance with regulations. Future work is also expected to incorporate the quantification, weighting and incorporation of deficient corporate management and sub-optimal risk management practices as key triggers for invoking corrective measures and penalties. To support the long term implementation of these practices, the Superintendency needs to be provided with resources to strengthen its supervision procedures, provide staff training, upgrade its knowledge of risk management analysis and modernize its systems for evaluating and monitoring banking risk.

26. *Addressing the Non-bank Financial Institutions:* To ensure the prudential management of non-credit institutions, other priorities include the reform of solvency standards and consolidation of the insurance and non bank sector regulatory framework. Priority will be given to upgrading insurance industry regulations, including the proposed adoption of actuarially sound solvency margins particularly to ensure more adequate technical reserve provisioning for both health insurance and general insurance risk exposures. The upgrading of regulations and guidelines for the trust industry is also required, particularly with the advent of new products to be managed, such as asset securitizations and managed funds for third parties.

Prudential Regulation and Supervision - Background and Diagnosis of Issues

27. Since the beginning of the past decade Colombia exhibited a relatively complete and advanced prudential regulatory framework. The initial financial crisis reforms were anchored by several crucial laws that provided the basis for empowering the Superintendency to manage the crisis, regulate debt and bank restructuring, require and enforce remedial actions, and revise previous prudential regulations. For prudential regulation, the most important pieces of legislation were Law 510/1999 (which updated the Organic Statute of the Financial System and gave the Superintendency additional powers to improve prudential regulations and effect enforcement) and Law 550/1999 (which set the path for the restructuring of problem loans).

28. *Future Development of the Regulatory Framework*: The most important regulatory priorities, in the near term, would be directly related to the latest Financial Sector Reform, and evolve around some of the provisions of Law 795/2003. Regulatory priorities of the SB include, inter-alia: (a) strengthening the definitions of bank insiders, so that comprehensive supervision of financial conglomerates can take place, including real sector related parties; and, (b) establishing a consistent, homogeneous and transparent, framework of criteria to administer remedial actions.

29. Under Decree 1775/2002, the Government also revamped the internal organizational structure of the Superintendency, advancing changes that will enable supporting the approach that is to preside over the development of the supervisory agency during its next strategic cycle. By this decree, supervisory resources were concentrated into five delegated Intendencies ('Delegaturas') of the Superintendent, merging together onsite examiners and offsite analysts, and nominating new Directorates to provide for essential support functions such as Supervision, Regulation, Technical Analysis, Legal, and IT and data processing.

The Government Reform Agenda for the Banking System

The First Operation under the Program

30. Given the above issues, and the need to assure a full and sustained recovery of the financial system, the Government has embarked on a second round of reforms of the law governing the financial system. Key objectives of this reform are to provide additional tools to ensure a non-traumatic and market oriented restructuring of the financial sector as well as additional regulatory and supervisory tools to effect prompt corrective actions and avoid deterioration and contagion from mismanaged financial institutions. The Government reform program thus contains the following key policy actions:

Corporate Governance, Rules of Conduct and Client Protection

31. *Governance.* The new financial system law incorporates a number of rigorous norms to ensure proper governance of financial institutions. Proper corporate governance in a sense, is the first line of defense to protect the viability of banks and generates a culture of self regulation by requiring transparency and accountability by the management and Boards of institutions. The reforms of the law, set out norms to ensure Board independence and strengthen the code of conduct including risk management and ethical responsibilities of managers and directors. A key provision in the reform which puts additional force into these norms, is the strengthening of a regime and schedule of sanctions which extends its applicability beyond bank managers to cover administrative officers of various degrees of responsibility, Board Directors, legal staff, bank auditors, as well as other officials designated with a particular fiduciary role such as officers in charge of monitoring money laundering activity.

32. *Strengthening Sanctions.* Another aspect relates to the available sanctioning tools of the Superintendency of Banks (SB), both for corporate governance norms as well as standard prudential norms, pertains to the establishment of time bound periods for institutions to comply with SB directives issued previously, with particular focus on loss provisioning requirements, wherein, lack of compliance within specified periods, automatically leads to additional sanctions or fines for persistence of a given unprudent practice. This aspect of the new law strengthens the resolve of the regulatory framework to ensure that institutions no longer count on time delays or other legal procedures to avoid meeting their outstanding obligations without penalty.

33. *Conflicts of Interest.* The new law, in addition, sets stricter controls on banking operations to avoid conflict of interest situations. Specifically, under the new framework, Boards of Directors of financial institutions are required to vote by unanimous decision in order to approve any lending or deposit taking activities with any of its shareholders or their relatives (or administrators of the institution) which happen to exceed five percent of the institution's share of ownership. The measure forces transparency as well as accountability by Boards of Directors, to ensure that banking operations are not put at risk via the concentration of transactions in key shareholders or stakeholders of the institution, and who might otherwise unduly influence the polices of the institution to meet their specific investor interests rather than those of the majority of shareholders.

34. *Client/Consumer Protection.* The reformed legislation also sets out regulatory requirements for financial institutions to comply with information transparency norms to adequately disclose their products, pricing norms, terms and inherent investment risks and

protections applicable to clients. The new law, in addition, establishes the internal public liaison function of the 'client advocate' to be implemented within each financial institution and which will serve as a first recourse instance to internally resolve and address any complaints emanating from clients of said institutions, before such issues are escalated to the SB for handling or for undertaking any required regulatory action.

Enforcement Powers

35. As part of the revised legal framework, a number of areas of modification relate to the SB's autonomy as well as special powers to ensure prompt reversal of risky actions engaged by financial institutions or their parent economic groups. In this context, an innovative approach to supervision of consolidated groups is promoted by authorizing the SB to inspect companies within those economic groups not traditionally subject to SB's supervision. This will permit more leeway for the SB to uncover related party operations or double counting of capital or assets within financial groups and/or larger economic groups which go beyond the financial system. In addition, the new law also establishes a sanctions regime for implementation in the event of conflict of interest breaches which involve bank operations with subsidiaries or related institutions.

36. Another key aspect for optimizing the enforcement operations of the SB, pertains to its degree of autonomy in carrying out the necessary actions in a timely manner when dealing with problem institutions. For this purpose, the new financial system law grants the SB autonomy to enforce regulatory norms under its mandate including the promulgation of directives and application of sanctions to non complying entities. The new law also paves the way for future development regulations which would allow the SB to take possession or intervene a bank when necessary, without prior approval from the Finance Ministry.

37. The rationale for this change is not only to provide the SB with the operational autonomy that it requires, but also to avoid delays in the execution of prompt corrective actions which would otherwise potentially contribute to the further deterioration of financial institutions before appropriate steps could be taken. In addition to decision making autonomy, the new law also authorizes the SB to have additional budget autonomy in terms of its internal resource allocation where this pertains to resources raised through regulatory fees and not through any central government budget transfers. This will provide the SB with the needed flexibility to manage its internal resources according to technical and logistical requirements. To support this, the new law paves the way to provide future presidential authorization to establish a special career regime for the SB, in order to train and retain qualified and adequately compensated personnel.

38. Consistent with the above, the reform program also includes the preparation and approval of the SB's institutional development and strategic plan. The plan includes the upgrading of supervisory policies to be reflected in updated manuals and procedures, as well as the planned implementation of risk rating methodologies to monitor subject banks and assess potential vulnerabilities. The plan also includes increased SB capacity to train, recruit as well as adequately compensate and retain qualified supervisory personnel under a budgetarily sustainable career development program.

Regulatory Infrastructure, Financial Stability, and Tracking of Sensitive Funds

39. *Regulatory Costs.* The monitoring of not only potential credit risks but new market risks too, and the move towards the latest Basle reforms, has resulted in a heavy information reporting

requirement for financial entities. In this regard, the Government has confirmed its initiation of an exercise to assess opportunities to reduce the regulatory costs and rationalize reporting requirements of supervised entities, where necessary, and avoiding duplicate requests from separate units within the SB or other financial and/or regulatory authorities. In addition, the reduction of reporting requirements following the end of the 1998-2000 crisis was not fully recognized by all entities, hence a review of all current requirements and proposals for rationalization will be conducted. For the first loan under the programmatic operation, the Government has started conducting the regulatory reporting rationalization exercise. Once the issues have been diagnosed and identified, the Government will, under the second loan in the programmatic operation, implement the reporting and cost rationalization measures.

40. *Payments System Risks.* The new legal framework also clarifies and confirms the authority of the Central Bank as it relates to large payment systems transactions. This is important given that, while the previous banking law alluded to the Central Bank's role in oversight of the payments system, it did not fully confirm the CB's regulatory authority in this area which was left undefined between the CB and the SB. The new law thus confirms the CB's authority in particular as it relates to large transactions and thus allows the CB to set or modify the rules of operation of the payment system in this area, as needed for efficiency or enhanced security. At the same time, given the proliferation of smaller payment system transactions such as those executed via debit cards and credit cards, the new law gives the SB powers to supervise such operations. The legal framework thus clarifies and maintains the CB as the overseer and authority in terms of the large non-retail payment transactions which constitute the bulk of fund movements in the financial system, while the SB retains authority over other payment system operations associated with specific lines of business or retail products.

41. *Anti Money Laundering / Countering Terrorism Financing.* Given Colombia's particular social and business environment affected by both the guerrilla insurgency, the associated drug trade, and the potential for large sums of laundered illicit funds, the financial reform, through SB's issuance of new procedural regulations, strengthens the special anti-money laundering information intelligence unit which is ascribed to the Finance Ministry. Colombia's anti-money laundering framework and countering of terrorist financing is already well established given the framework law No. 526 of 1999 which established a special financial intelligence unit for this purpose as well as the earlier banking law of 1999 which set out the obligations of financial institutions in reporting suspicious transactions. Since then, a number of regulations and decrees issued by the Banking Superintendency as well as the Revenue and Customs Department (DIAN) and the Superintendency of Notaries, have reinforced the institutional and private financial business accountabilities in reporting illicit transactions which are channeled for analysis to the financial intelligence Unit (UIAF).

42. The UIAF, besides entering into inter-institutional agreements with other State entities including police, crime detection, auditing, cadastral and tax institutions, has also set up a complex multi-feed information database system (the centralized information query system or the SCCI) which matches financial information with particular geographic, business, residential, legal, and other attributes, to detect most likely transactions which originate from illicit sources and which fall into the AML/CTF oversight framework. To further strengthen the UIAF's oversight and detection mandate, the new financial system reform law requires that all financial sector institutions submit (electronically) all information related to cash transactions equal to or above US$5,000 equivalent directly to the UIAF for processing and screening. The UIAF, following its procedures would identify any transactions subject to suspicion based on other

attributes including reasonableness of source and size of income in the given area and sector, and forward any likely candidates to the Attorney General's office for follow up and legal or police action. To further augment the detection capabilities of illicit funds, the new law also gives the SB authorization to monitor the destination and composition of offshore investment monies of domestic financial institutions.

43. *Financial Stability and Contingency Planning.* Finally, in order to ensure that the recent effects of the 1998-2000 crisis and their resolution contain the seeds for sustainable financial sector health and stability, the government intends to carry out a sensitivity and diagnostic review of the condition of the financial system. The commitment to conduct such a review and its core parameters are defined as part of the first loan under the programmatic operation, and the execution and finalization of it will be implemented by the second operation. Essentially, the review will evaluate the risks posed by remaining weak or vulnerable banks and financial institutions and assess their potential performance under scenarios of low or no growth in the economy, including their capacity to service loans, and where applicable, their capacity to repay FOGAFIN loans which were extended to them as part of an institutional capitalization scheme during the crisis.

Mechanisms for the Resolution of Problem Banks linked to the Operations of the Deposit Insurance Fund

44. During the 1998-2000 crisis years, the earlier changes to the banking law had enabled FOGAFIN, the deposit insurance and bank restructuring agency to move away from outright intervention and subsequent immediate liquidation of failed banks towards a less traumatic method which preserved asset value, and whereby viable bank assets were matched against deposits and packaged as "partial balance sheets" for sale or transfer to another acquiring bank with a healthy solvency condition. In theory this approach was more progressive and avoided running up fiscal liabilities on account of payments to depositors which could not be funded with underlying assets (until after full liquidation). In practice, however, the transfer to other banks, of viable remaining assets along with depositor funds, was made more difficult during recessionary periods where demand was lacking and the value of such assets was uncertain. In addition, bank shareholders and managers resisted the break up of their bank into parts, and instead preferred to undertake supervised rehabilitation plans.

45. *Restructuring Powers.* Under the new financial system law's reforms, many of these aspects are improved to allow implementation of a more effective and workable bank resolution procedure. The new law defines more precisely the SB's powers and authority in this regard, so that once a bank is deemed unviable from a solvency perspective, and following the possession of said bank by the SB, the asset/liability carve out procedure becomes automatic rather than optional. The idea is to minimize moral hazard and essentially undo a banking operation which is clearly insolvent yet can be absorbed in part by other institutions. In this regard, given that the subject bank no longer has sufficient regulatory capital to be licensed for operation, the SB may automatically proceed to determine the most optimal asset/liability carve out procedure without the consent of the shareholders or managers.

46. *Securitization Instruments.* However, the more innovative aspect covered under the new law, is the active use of asset securitizations to enable a more effective transfer of portfolios with associated liabilities (e.g.: deposits) to acquiring institutions. With the establishment of an asset securitization company in Colombia as well as the start of the mainstreaming of the

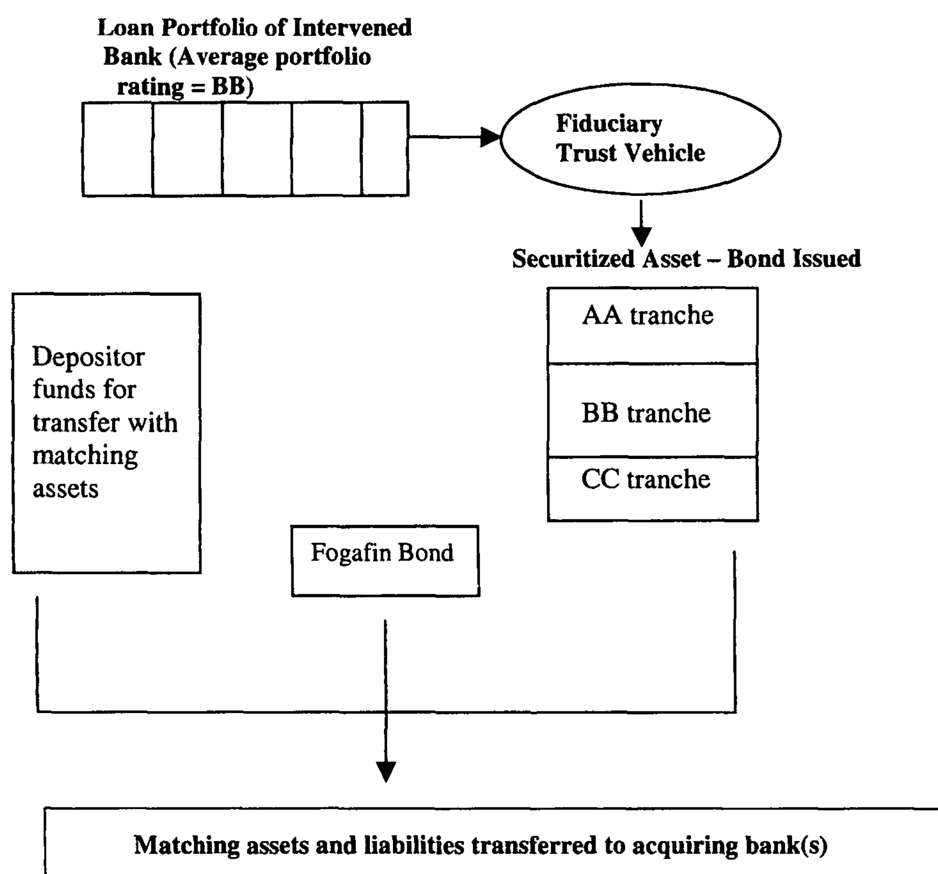
securitization industry, this mechanism provides an efficient means of transferring underlying loan portfolios to other banks, without the uncertainties of asset valuation or loan recovery prospects inherent in the earlier approved procedures. The securitization method permitted as part of the resolution tool kit under the new law, is set up by transferring the viable loans of the subject bank, into a trust which subsequently issues securities (e.g: bonds or notes) whose yields are based on the projected cash flows of the underlying portfolio. The securitized bond is normally over collateralized, that is, a portfolio of underlying loans of significantly higher nominal value than the bond's face value, is used as the underlying asset pool to back the bond(s). In this way, the non repayment of part of the underlying portfolio would not necessarily affect the bond's performance, at least within its more 'senior' tranches.[1]

47. *Fiduciary Trust Vehicles.* Under the new law, a key provision in making the resolution mechanism more effective, is the use of fiduciary trust vehicles to house the underlying portfolio and to issue the securitized bond. The advantage of this approach, particularly for those bond holders within the senior tranche, is that loan portfolio valuation becomes less of an immediate requirement and therefore assets can be transferred more expeditiously via this instrument. To complement the transfer of assets to acquiring banks under this instrumentality, the new law also permits FOGAFIN to utilize its own bonds, guarantees, or if needed, deposit insurance funds[2]. Purchasing banks, from a regulatory perspective, need to have a slightly larger asset base for every similar value batch of new deposits they acquire in order to have an adequate solvency margin. Thus, a transfer of deposits (which avoids fiscal pay-outs of deposit insurance funds) and which are matched by securitized assets, may not always be viable if the Government wished to maximize the amount of deposits transferred to other banks. Therefore, the new law provides additional flexibility for FOGAFIN to "add" assets to the partial balance sheets of those acquiring banks, so that they might have enough viable assets, including the securitized ones, to assume the mass of deposits desired. The "added" assets, thus, can take the form of additional bonds issued by FOGAFIN and backed by deposit insurance resources, or FOGAFIN contingent guarantees to cover any unexpected defaults on the securitized portfolio, or outright cash assignments in lieu of deposit insurance payments.

[1] The securitized bond can be broken up into subordinated/junior, mezzanine and senior tranches. Each tranche receives a successively higher repayment priority so that the senior tranches are 'preferred credits' in that they have first guarantee of payment proceeds, while each successive tranche is guaranteed payment only based on the residual cash amounts received after paying the higher tranches. Thus, the most subordinated tranche has the lowest credit rating for investment purposes.

[2] Provided that the amount utilized is equal to or less than any amount which would have been required as a direct cash pay out to depositors, if no asset/liability transfers had taken place.

Securitization Structure Used as Bank Resolution/Asset Transfer Mechanism



Matching assets and liabilities transferred to acquiring bank(s)

48. *Phased Asset Carve Outs.* Finally, an additional modality authorized under the new law, applies primarily to institutions that wish to voluntarily close down due to unfavorable future business prospects. Under this modality of "progressive dismounting" the SB and FOGAFIN are authorized to oversee a gradual carve-out, reduction and sale of assets of a financial institution in order to decrease its operating balance sheet progressively until a minimum of core assets remain which can be liquidated outright. This modality, which also avoids immediate liquidation of all assets and State pay-outs to depositors, and does not necessitate the quick transfer of asset/liability packages to other banks, nevertheless provides regulatory flexibility for banks which voluntarily decide to close down, permitting an orderly exit from the market.

49. *Asset Management Modalities.* To increase the administrative flexibility in managing any residual assets which may not be subject to securitization under the above scheme, and which would require liquidation and/or foreclosure of underlying assets, the new law also authorizes banks and fiduciary companies to offer services for the administration of assets and trustee services, respectively, in order to undertake portfolio management for institutions undergoing liquidation. This measure allows further 'privatization' of asset liquidation exercises previously conducted primarily by CISA, the government's asset management/liquidation company, for the officialized banks; and the measure also provides private banks and trust companies with adequate legal tools and instrumentalities to conduct such work as separate lines of business which can remain as off balance sheet activities given their fee based nature and objective as a specialized financial service. At the same time, the new law provides CISA itself with additional flexibility to conduct its asset management functions. CISA, while State owned, operates under

the private contractual regime, and the new law now permits it to utilize securitization procedures in order to enhance its asset sale/liquidation options which would help to accelerate such processes. With this legal change, CISA is thus authorized to engage in enhanced asset management procedures and permitted to take on trustee functions. Thus, entities undergoing liquidation may have their assets administered by CISA under both trust arrangements as well as standard asset management contracts.

50. *Deposit Insurance Policies.* The work of FOGAFIN itself, while receiving more attention under its bank restructuring operations, is principally one of managing insurance funds for depositors. During the 1998-2000 period, the Government transferred resources to FOGAFIN to capitalize its insurance fund more adequately given the expected bank failures at that time and the need to have deposit insurance and bridge funds during the restructuring or liquidation processes of banks. Following that period, however, the actual indemnities paid to depositors under the insurance scheme were reviewed with a view towards ensuring fairness both in terms of coverage as well as in terms of deposit insurance premiums charged to deposit taking institutions in the financial system. Under the new legal reforms these issues are addressed and modified as follows: While previously, deposit insurance payments contained a co-insurance element whereby depositors paid a percentage of their coverage out of their own pocket (akin to a rolling deductible), the new law excludes this provision and provides FOGAFIN the flexibility to set the co-insurance deductible at a level starting from zero. In this manner, the smallest depositors need no longer pay a co-insurance deductible which would otherwise mean that they immediately lose that portion of their deposits if a bank fails. Instead, FOGAFIN, within the limits of coverage established, would pay small depositors 100% of their deposits as long as they were equal to, or below the coverage limit. The law also formalizes an adjusted premium approach charged to banks, and authorizes implementation of a 'rebate' program whereby the risk based premium is adjusted on an ex post basis by refunding to those banks in good standing a portion of their premiums paid at the start of the year, or charging additional premiums if they are not in good standing.

Restructuring and Resolution of the State Owned Banks

51. As discussed earlier, one of the large programs which involved government intervention and support concerned the State owned banks, many of which were officialized and put under direct oversight by FOGAFIN while they were restructured or wound down. In the process, most of the officialized banks were gradually wound down with portfolios or liquidated assets being sold off. The key remaining banks at the moment are Bancafé and Granahorrar which have yet to be fully resolved, sold or disposed of. In addition, the State still has the second tier lending banks although these have not had major portfolio and solvency problems with the exception of IFI (Instituto de Fomento Industrial). The Government has been considering a strategy to consolidate some of the second tier banks so as to reduce the State banking institutions.

52. *First Tier Banks.* In terms of the remaining two first tier banks[3] listed above, under the reform program the government has formally committed to privatizing Bancafé, with the sale process having already been initiated along with the hiring of an investment firm to manage it. While the privatization process for Bancafé is now well underway, the situation for Granahorrar

[3] Not including the Banco Agrario which was created from the merger of other institutions and which, as a matter of government policy will remain as the only first tier bank of the State, to serve the needs of the rural sector.

whose portfolio is less attractive is somewhat different. The Government's intention is to also eventually sell Granahorrar so as to capitalize on the remaining assets and avoid materialization of a fiscal liability. However, market demand for the bank has still not been identified and the Government is considering options for structuring a deal which would be well received by the financial industry. In this regard, the Government is developing a number of policy options to achieve a viable restructuring and sale strategy for Granahorrar, including the securitization of a portion of its assets as well as the issuance of bonds to fill any balance sheet gaps. The Government will evaluate these options in the context of potential market demand in order to arrive at a realistic determination of the optimal sale or disposal strategy for the bank. The legal and financial instruments authorized under the new law will also provide the government the needed flexibility to exhaust all possible avenues for providing the most secure package to potential investors.

53. *Second Tier Banks.* In the second tier banking sector, the Government has reinitiated its intent to rationalize that sector and improve the financial condition of its banks. Under the reform, IFI, the most problematic bank, has been put under a private contractual regime and is formally only permitted to engage in second tier lending operations. Following that, as part of the reform, the Government, through IFI's shareholders assembly, authorized the transfer IFI assets and liabilities as well as some of its operational infrastructure, into Bancoldex, the export bank, with any remaining untransferred assets to be liquidated. In effect this decision downsizes and merges these banks although Bancoldex is maintained as the legal entity and IFI is formally dissolved. To complement these measures and avoid future loss making operations of State banks, the new law also requires that State banks such as Banagrario and IFI set lending rates to fully cover financial and operational costs and credit risks, with no subsidies allowed in lending. The only exception which the law provides is if a given State bank can obtain separate budget resources transferred to it from the Government to engage in an explicit subsidized lending scheme, something which would require authorization at the highest Ministerial levels.

Prudential Regulation and Supervision –Phase I

54. Actions planned by the Government will focus on finalizing a complete inventory of the decrees required to develop the provisions of the new Financial System Law . The inventory will also include the external circulars that the Superintendency will need to implement the provisions of the new law (795/2003). In addition, the SB intends to ensure that as part of its 2003-2006 Strategic Planning cycle, it adopts a Supervisory Development Program to continue strengthening its capacity.

55. *Assessment of Credit Risk Parameters:* As part of the ongoing efforts of the Superintendency to implement a *circular* on integrated credit risk management processes, the SB has committed to develop terms of reference for an independent expert to review the overall consistency for approval of credit risk methodologies.

56. The Government intends to carry out two quantitative studies to provide input for further actions to follow strengthening the efficiency and stability of the financial system. The first study addressed earlier, will consist of a prospective stocktaking of the degree of progress achieved in restoring the health of the banking system. The second study intends to establish the effect of current regulations – economic, tax, prudential, reporting -- on financial intermediation, both in terms of regulatory and business costs. This study will also aim at identifying actions to mitigate such costs.

57. As part of the first operation supported by the Bank, there will be an agreement regarding the commitment and overall scope for such studies. As part of the programmatic approach followed by the Government, it is expected that the recommendations and conclusions emanating from these studies will be considered in taking measures to continue consolidating the health of banks and mitigating the effect of regulatory costs, including the adoption of additional actions to address any relevant findings by the time of the second programmatic financial sector operation.

Actions for Institutional Development of the Superintendency

58. *Supervisory Development Program*: The Superintendency has committed to developing a new Strategic Plan for the 2003-2006 cycle of operations of the SB, including among others, detailed components of a Supervisory Development Program to address the challenges and issues identified by the SB, in order to:

a) Design and formalize a revised risk based[4] operational Supervisory Strategy, to streamline, and integrate into current Supervisory Processes -- for licensing and authorizations, onsite and offsite supervision, and remedial, enforcement, and resolution actions-- whose steps would be charted, identifying major decision points, to ensure a consistent supervisory response;

b) Compile and update currently dispersed out-of-date Supervisory Manuals of Procedures, combining both solvency and risk based approaches, including computerized planning, and working programs and papers, in order to support supervisory assessments of financial institutions as per a new Risk Rating Matrix Methodology; and

c) Review, simplify, and make cost efficient, current Supervisory Products --such as examination reports, surveillance analysis notes, and CAMEL indicators -- ensuring a set of homogeneous executive oriented reports warehoused in accessible network computerized systems.

59. *Related Investment Projects:* The above plan will include any incremental investment projects that would facilitate implementing the Supervisory Development Program of the Superintendency during its planning 2003-2006 cycle, indicating the level of funds to carry out the necessary programmed actions, including consideration of major training sessions.

60. *Supervisory Staff Training and Compensation:* To resolve the current restriction impinging on the depth and caliber of supervisory staff, the Ministry of Finance has agreed to evaluate, and present alternatives to ensure that the Superintendency can effectively mitigate its deteriorating staff turnover ratio, as well as train and compensate its staff closer to market and institutional standards.

[4] To focus on risk accumulation at systemic and individual bank levels; centering on assessing both quantitative and qualitative aspects of risk, including the primary quality of assets and earnings, the availability of genuine residual capital, and adherence to sound standards of business and financial practices; and, looking prospectively at resilience to risks under stress, rather than to static measures of compliance with regulatory capital and risk limits.

The Second Operation under the Program – The Banking System

61. The proposed program for the second operation is described below. Under the second loan, the main areas covered anticipate: (a) full implementation of the required regulations emanating from the financial system reform law (including those for supervision of conglomerates, conflicts of interest, governance rules, and enforcement of sanctions), (b) actions to improve banking system efficiency by rationalizing tax and regulatory constraints and fine tuning the payments system, (c) measures to ensure systemic integrity through prompt application of corrective actions, (d) examination of contingency measures to assure safe operation of the banking system under adverse economic states, and (e) actions to improve the efficiency of the regulatory process and implement an institutional development plan for the Superintendency. While the main thrust of the program is further described below, the final policy agreements and specifics of implementation will be defined during the formal preparation of the second phase.

62. A key aspect under the second phase pertains to integrating regulations relating to the SB's enforcement actions including the span of remedial actions as well as subsequent schedules of pecuniary sanctions applied in a graduated manner based on the seriousness or persistence of given infractions. This section of the report addresses *banking sector* issues whose major reforms will have occurred under the first phase -- the subsequent sections address other various key subsectors including insurance, non-banks, securities, housing finance and the government debt market, where a major set of reforms will take place under the second loan of the programmatic operation.

Financial Efficiency and Systemic Integrity.

63. The second phase will also allow the government to review and address structural tax and regulatory rigidities in the financial system which could in the long term affect the competitiveness and the soundness of the financial system. While economic and credit conditions will remain a key priority in the oversight of the financial sector, the payments system and instruments used for generating temporary liquidity in the interbank market (e.g.: repos) will also be enhanced to prevent any transaction related default risks.

64. During the first phase of the programmatic operation, the Government has committed itself to conduct a vulnerability review of the financial system. Under the second phase, said study will have been completed and a contingency plan defined to handle any possible downturns, systemic effects, or institutional failures caused by lower than anticipated economic growth and other factors potentially affecting banking health.

Institutional Strengthening and Regulatory Process Efficiency

65. In order to ensure that the reform's progress and implementation of the new regulatory framework is sustained over the medium and long term, and as per the provisions for enhancing the SB's institutional autonomy under the reformed financial system law, under the second phase, the government will seek to implement a Strategic Plan for the institutional development of the SB over the 2003-06 period. Part of the institutional plan, besides the sustainable career development and compensation plan, and the approval of investments for the SB's development program , will include the establishment of ongoing internal risk ratings of financial institutions

so as to allow a more strategic approach to undertaking supervisory activities and focusing on vulnerabilities in the sector.

Prudential Regulation and Supervision

66. *Reduction of Regulatory Costs*: The Superintendency intends to diagnose and identify measures to rationalize its requests for prudential information, with a view to alleviate the regulatory costs associated with the current system of reporting requirements.

67. *Internal Corporate Governance Standards*: The Superintendency will implement, as well, regulations governing the codes of conduct and duties of bank boards and management, including a more detailed set of standards for bank board procedures, their functioning and their operating committees.

68. *Conflicts of Interest*: The Superintendency intends to establish, as well, regulations to implement articles of the Financial System Reform Law covering measures to mitigate conflicts of interest under major decisions and transactions where significant shareholders of an institution, directors or senior management, are parties.

Actions for Development of the Superintendency

69. By the time of the second programmatic operation, the Superintendency intends to have advanced substantially in specifying objectives and targets for a Supervisory Development Program, including selected benchmark indicators in the areas of internal governance standards communicated to the industry, market risk management and collateral valuation standards, as well as full disclosure of its sanctions regime and associated fines, improved and documented supervision procedures and examination strategies, and implementation of the supervision of consolidated groups including offshore entities.

C. Housing Finance

Background

70. The housing finance crisis was caused by massive unemployment, excessive levels of UPAC-denominated loan rates, unsafe underwriting standards, falling housing values which created negative equity and wealth losses, and a spreading culture of non-payment fueled by court rulings adverse to lenders. Non-performing loans represent 24% of mortgage loans, although that level when expressed in nominal pesos stopped deteriorating in 2002 (at 2 trillion pesos, plus 0.7 trillion of foreclosed assets).

71. 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 rapidly rising 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 higher interest rates which 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, and repossess real estate assets, 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 (the UPAC), based on average interest rates levels, was invalid since an inflation based index should have been consistently used over the years, and therefore this ruling prompted the government to refund on an ex post basis many of the interest charges to borrowers which would have been lower if a non-interest rate index had been used. 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.

72. The housing finance law No. 546 was approved in December 1999 in order to keep the housing financial industry alive but rebuild solid foundations. The main blocks of reforms were:

(a) Savings & Loans institutions ("CAVs") were converted into fully regulated banks, subject to diversification, and tighter loan-loss provision rules (some institutions being restructured by Fogafin or closed).
(b) The Government through FOGAFIN, purchased CISA in 2000 as an asset management company to dispose of the bad loans including mortgage ones, from restructured banks, primarily Bancafe and BCH. Despite a slow start, CISA has paralleled the efforts of the private banks in active debt recovery and loss mitigation[10].
(c) Fogafin has been operating a credit enhancement program for mortgage securities refinancing social housing loans ("VIS"). Until 2001, it has also provided some

[10] By September 2002, CISA purchased $925 million of assets (peso 1.6 trillion from Bancafe), and disposed of $370 million. About 44% of the assets were mortgage loans. CISA plans to sell $185 million of assets in 2003 and complete its sales by 2005.

subordinated credit lines to shareholders of banks to help these meet tighter solvency goals. It also sold its own portfolio through a competitive bidding process.

73. Most banks have learned to pursue active mortgage debt recovery and mitigate their losses. The coverage ratio of mortgage loan-loss provisioning has steadily increased up to 39% as a result of tighter prudential regulations set by the SB. Many of these loans correspond to households that stopped repaying for various reasons more than a year or two ago. Most have already been restructured but loss provisions need to increase as the classification worsens.

74. The quality of the portfolio and the revival of sound loan production depends on the evolution of housing prices and of a stable macro and judiciary environment. The housing sector started to revive in 2002 after three years of distress. There is a reported 20% increase in new construction as households have resumed investing in housing, even if carefully. Demand was boosted by new tax benefits offered in 2002, for new mortgage borrowers.

75. Most mortgage lenders are now liquid but remain vulnerable to credit and market risks. The ex-CAV banks are still struggling to diversify their production into more profitable sectors. Most struggle to meet stricter regulatory solvency ratios and have had to leverage using the re-capitalization lines provided by Fogafin to the shareholders. Fogafin stopped extending these credit lines after 2001 and is now actively monitoring inherent risks and bank repayment capacities, including if needed, collateral strengthening actions.

76. Banks have not yet entered into contracts using the FRECH fund created as a transition policy instrument to hedge their market risks resulting from the UVR portfolio conversion, because of the high (and inadequate) level of the triggers under that swap contract, compared to the actual low real market rates. The FRECH fund was created by law as a transition measure to partially hedge the increased market risk exposure of banks whose mortgage portfolios were converted in 2000 into the UVR index. This sizeable fund – now of 350 billion pesos - was partly financed by taxes imposed earlier on transactions within the financial system, and is administered by the central bank. Its swap design has been conservatively priced to preserve the fund in a range of risky environments, and to protect lenders against significant spikes in real market rates.

77. Under current circumstances, any contracting institution would have to pay expensive contributory fees (adverse to its profitability), with further unpredictable yearly flows. Despite extensions and minor adjustments, banks have not found the mechanism attractive enough to contract, as short-term real rates have remained low. Banks have remained exposed to large market risks although the eligible portfolio for this mechanism, is amortizing through time, and shareholders instead borrowed re-capitalization credits from the state through Fogafin to meet SB's capital adequacy requirements for credit and market risks. Therefore alternative hedge instruments and their design are being considered to modify the FRECH mechanism.

78. In a major advance towards the access to long-term funds for mortgage lenders, securitization is again operational. It is a useful instrument to manage liquidity and market risks, and to leverage scarce capital. A sizeable amount of high-quality mortgage loans was successfully securitized in 2002 at favorable conditions [11] through the new securitization company that was capitalized by the majority of the ex-CAVs. But this initial phase remained

[11] About Peso 1 trillion through two securitization programs, the latest was placed under the following conditions: interest rate at UVR +5.4%, terms between 5 and 15 years, with moderate structuring and trustee fees.

largely driven by large tax advantages, as the offering banks later purchased and held a large part of these mortgage backed securities (MBS) to capture the tax exemption on MBS interest. Their exposure to market risk was then only partly reduced, as about 30% of the senior rated MBS bonds were acquired at issuance by a diversified group of other investors (mutual funds, insurance companies, pension funds). The sustainability of securitization should be developed on its own merits with sunset rules after 2004 to phase out disputable, regressive and fiscally costly tax subsidies. Nevertheless, the tax exemption has helped the housing finance sector to raise new funds increasing the availability of mortgage finance to new borrowers. The exemption does not apply to the securitization of other non mortgage loans, as utilized for more generalized banking resolution procedures.

The Government Reform Program in the Housing Finance Sector

The First Operation under the Program

Housing Finance and Mortgage Market Reforms under the New Financial System Reform Law

79. Under the first operation, the financial system reform law and the reform of the civil procedures code include several fundamental elements that will enhance the development of the housing finance sector in Colombia. These include the following:

- Reducing the complexity, length and costs of the mortgage foreclosure process.
- Facilitating the leasing of foreclosed assets by mortgage lenders as a remedy to cases of delinquent mortgage loans.
- Granting CISA abilities in the financial management of assets, in order to strengthen its credit pledge enforcement capacity and contract external servicing companies. After having set up automated systems and organizational capacity, CISA should be able to dispose of assets even more rapidly.
- Facilitating procedures for bank privatization and/or close ending resolutions.
- Extending micro-finance to housing with permitted additional administration fees, and open access for lenders to the credit guarantee program of the Fondo Nacional de Garantias (National Guarantee Fund). By giving banks special provisions to extend micro housing loans as well as permitting banks to fund credit lines for finance companies for the same purpose, this will permit a broader outreach to potential homeowners who traditionally have not had direct local access to housing credit institutions.

Inflation / Interest Rate Hedging Mechanisms

80. Other reforms undertaken as part of the program under the first operation, include an actuarial study to review the guarantee enhancement program operated by Fogafin since 2002 for mortgage securities which finance social housing loans ("VIS"). Fogafin has been charging 81 basis points for its support of securitized loans that would meet eligibility criteria, and 32 basis points for its insurance/credit enhancement program to support mortgage bonds issued by banks. This program was originally envisaged as lasting two years, as an incentive to spark the growth

and trust in mortgage securities, by extending a state guarantee that would reduce funding costs of VIS loans (capped by law at UVR + 11%). The premium will be updated and differentiated according to the net risk exposure, and so that no type of security structure is favored in a non-economical way. Should the program be extended, sunset clauses will be clearly announced and/or the program will be transferred to a regulated professional insurance institution.

81. Another constructive use of FRECH, implemented under the first operation and which is not a hedge mechanism but simply deploying the liquidity accumulated and available in the FRECH fund, consists of it acting as a liquidity backstop facility for the newly developed mortgage securities markets by permitting the swapping of eligible mortgage securities with repo-able government securities. This use of FRECH has been approved and the Central Bank will promulgate its methodology to determine the corresponding pricing haircuts. It will also adjust the general valuation rules for debt securities, to the specifics of mortgage securities, which are infrequently traded through secondary markets, as well as valuation methods for and embedded callable options.

82. Simultaneously, while the FRECH hedging mechanisms is being modified, Fogafin has developed operational guidelines for a new UVR-swap program operated through by it on behalf of the Government. The guidelines have just been disclosed through the recent Decree 66 of January 15, 2003. The swap is directly contracted between Fogafin and eligible borrowers through the partner credit institutions. It is applied against the UVR level and a fixed 6% peso interest base, and pertains to the next 40,000 eligible housing loans for a limited credit amount until mid-2004. The program is designed to regain trust by the population of UVR mortgage loans, using a hedge against any catastrophic inflation risk. The program represents a long-term bet on inflation. Should inflation fall below 6%, reassured households would stop contracting, but if inflation exceeds 6%, pressure may materialize to enlarge the program beyond its current size and format. In this context, the government will take care to avoid resulting in fiscal liabilities which could be detrimental to the overall national housing policy. Fogafin will also establish prudential financial reserves institutionally, and has developed its own hedging strategy against inflation risk to support this mechanism and to avoid any undue accumulation of contingent risks.

The Second Operation under the Program – Housing Finance

83. The proposed program for the second operation is described below. The second phase of the program will include progress in the implementation of: (a) harmonized rules for capital adequacy between banks and securitization companies, particularly with regard to securitized asset instruments, (b) reform of the swap inflation hedging mechanisms, (c) regulatory measures to increase the competitiveness of the mortgage industry, (d) developing alternatives for inflation indexed mortgage loans, (e) improving the micro finance infrastructure to increase credit access, and (f) creation of a national housing information center. While the main features of the program are described further below, the final policy agreements and specifics of implementation will be defined during the formal preparation of the second phase.

84. *Regulatory Improvements*. Harmonized rules for capital adequacy and loss provisioning between banks and securitization companies are expected to be implemented, with respect to their net exposure to risks generated from holding or guaranteeing different tranches of mortgage securities, so as to avoid regulatory arbitrage detrimental to the soundness of the financial sector.

85. *Industry Efficiency.* Additional measures will also be explored to make the mortgage lending industry more competitive and efficient. Competitive mortgage lending would be accelerated by some newly-licensed credit institutions, acting either as commercial banks or as non-depository specialized mortgage finance companies. The permitted use of external providers of specific and unbundled mortgage finance services (origination, appraisal, servicing, etc.) would increase the efficiency of mortgage lending by leveraging their respective comparative advantages on operation costs and risks.

86. *Market Benchmark Indices.* Alternatives will be considered regarding the lack of liquidity attached to the imposed UVR-indexation of mortgage securities. Since there is no liquid UVR benchmark, the affordability of housing finance is affected by a liquidity premium.

87. *The Tax Regime.* The taxation of housing finance along with exemptions will be assessed from various perspectives (fiscal authorities, borrowing households, lending institutions, investors of mortgage securities). The slow recovery of the housing finance industry may not tolerate too unfavorable and unexpected changes in the tax regime, but some rules need to be reformed for the system to be more consistent and efficient.

88. *Real Estate Valuation and Micro Finance.* Additional infrastructure is needed for the development of micro-finance as applied to housing investment. Links with formal VIS social housing subsidies are needed, as well as housing savings products, risk analysis tools, eligible distribution channels, institutional strengthening, market-oriented pricing and refinancing products. A national housing information center is needed to provide updated, reliable, and accessible information on the evolution of housing markets and actual market prices.

89. *Market Instruments and Infrastructure.* The FRECH fund will be reformed into a more effective hedging mechanism through the concerted efforts of a working group. Parametric changes would be justified, or alternative hedge structures will replace the swap design, particularly through interest rate options or extended credit enhancements to non-VIS mortgage securities.

D. The Insurance Sector and Non Bank Financial Services

Background

90. The key regulations that kicked off the liberalization of the insurance activity were Laws No. 45/90 and No. 9/91. The Superintendency of Banks is the authority responsible for the supervision of all the financial institutions including insurers and other non-banks, but excluding securities market players and small mutual cooperatives. The Delegatura de Seguros is the Department within the SB that specializes in the control of the insurance industry. While the SB is responsible for supervision, Law 35/93 established that a Technical Vice-Ministry of the Ministry of Finance (Hacienda) would be the Regulatory Body.

91. Insurance companies must specialize in either the Life or the General Insurance sector. Presently there are 28 companies licensed for General Insurance and 23 for Life. Most of the Life Insurers are sister companies in the same group as that of a Non Life Insurer.

92. Insurers are required to regularly submit to the SB financial returns and other types of schedules. The most recent regulation that defines the information that must be regularly forwarded by insurers to the SB was issued in December 2002 within the External Circular No. 052. The last relevant Law that regulates the Financial System Law 795/2003 which applies new reforms to the entire financial system.

Corporate Risk Management – The SEARS Approach

93. The SB, through External Circular No. 052 of Dec. 2002, established the requirement for adopting formal procedures in the analysis and measurement of all risks that affect the development of activities of any insurance company. Each insurer is requested to produce its own SEARS method (Sistema Especial de Análisis de Riesgos de Seguros) which must be approved by the SB. A time schedule for the implementation of SEARS has also been issued.

Reinsurance

94. Reinsurance plays a key role in the proper development of insurance activity. However in some cases reinsurance is used for non desirable purposes such as "fronting" for example, where the insurer does not retain any risk, passing most or all of it to the reinsurer and operating as a mere intermediary.

95. According to the Colombian regulations, foreign reinsurers do not need to have a domestic company to operate in the Colombian market, but they must register at the SB which monitors that market using: (a) A specialized reinsurance surveillance scheme; (b) Support to specialized inspection activities regarding the reinsurance programs of each insurer; and (c) Impact on the solvency margin of ceding companies, in the case of excessive use of reinsurance.

96. The SB is seeking ways to eliminate financial reinsurance and to reduce "fronting" operations, limiting them only to those cases where it might be technically required.

97. The existing regulations also affect reinsurance brokers which are required to be domiciled locally and are subject to a sanctions regime against malpractice. The register of reinsurers is granted only to those that count with a satisfactory evaluation of an international specialized rating agency.

The Trust Industry

98. The Trust agency industry ("Fiduciarias") in Colombia has grown into a significant player in the domestic financial markets. At the present, thirty one actively operating Trust companies exist and are subject to the Financial System Law which governs banks and other financial institutions. Trust companies are authorized to invest funds as trustees for third parties, to enter into contracts for the administration of assets (both real and financial), to administer collateral guarantees to assure financial obligations of third parties, and to administer or oversee any assets underlying the execution of any such collateral guarantees. They are also authorized to act as agents for the registration and transfer of securities as well as custodians of assets held under judicial procedures. Trust companies can also provide fee based financial advisory services. A high growth area in the Trust business has been the management of mutual funds as well as pension and retirement funds. Mutual funds managed under trust arrangements account for over 11% of all funds held under trust in the industry.

99. The fast evolution of the trust business and its fiduciary role in managing a large stock of investment assets, has prompted the authorities to examine closely the risk management requirements and responsibilities of the industry and to start developing appropriate regulatory norms commensurate with the current development of the market. At the same time, industry participants understanding their growing role in the financial markets in Colombia and the potential for increasingly diversified business lines, have begun proposing regulatory changes to provide the trust industry more flexibility to offer products in line with what they perceive as growing market demand. In this context, the reform program for the trust industry addresses both prudential risk management requirements and the need to avoid regulatory constraints for market development.

The Private Pension Sector

100. The private contribution defined pension system was established in 1993 following the approval of Law No. 100. Prior to that, the State run defined benefit social security system was the only pension provider for obligatory retirement funding. Private pension management firms (AFPs) are currently a significant player in Colombia's capital markets. Currently there are seven AFPs operating in the industry which manage obligatory pensions for workers in both the private and public sectors.

101. Pension assets managed by the AFPs currently amount to Col$15.7 trillion or US$ 5.4 billion equivalent. During the last five years, pension funds managed by the AFPs yielded an average rate of return of 20.7% per year, equivalent to a real rate of 9.9%. The current number of affiliates to the private pension system is 4.7 million individuals. Of these, a little under 50 percent are active contributors. Inactive affiliates are those who, due to unemployment or other factors, have not contributed within the last six months.

102. In terms of investment instruments in the portfolio, the primary categories constitute government securities which represent 49 percent of AFP portfolios, while financial institution securities represent 21 percent and corporations outside of the financial system, 20 percent. In currency terms, the portfolio includes 57 percent of investments in local nominal currency, 15 percent in inflation adjusted instruments, 22 percent in dollars and 4 percent in euros. The SB regulates a minimum rate of return required on AFP portfolios, and which is specified as a maximum downward deviation compared to a rate of return yielded by: (a) *a*

benchmark/reference portfolio of lower risk securities, and (b) *the average AFP industry return*; with each of these two factors having a 50 percent weight in the calculation. The reference portfolio is referred to as the "synthetic portfolio" and is constructed by the SB.

103. The public defined benefit pension system still remains open to new affiliates, but recent reforms have helped reduce benefits in order to lower the projected actuarial deficit. Under the public system there exists the main social security system (ISS) as well as other specialized funds for government and congressional workers as well as specific sectoral (teachers military) pension funds. In addition, territorial and municipal funds are being consolidated into a common funding mechanism (FONPET) to better manage their combined actuarial deficit. The specialized sectoral/professional public pension funds are partially funded with close to Col$ 3 trillion in reserves although, the same is not the case with the social security and government workers' funds whose reserves fall very short of future obligations. Affiliates in the main public funds (ISS, Government, Congressional) amount to almost 4,600,000, about the same number as in the private system.

The Government Reform Program for the Insurance Sector and Non Banks

104. Before reaching the second stage of implementation of the SEARS approach and the introduction of a multi-factor model to establish risk based capital requirements, the government, in line with prudent practices will implement the following changes to the present regulatory regime, as discussed below.

The First Operation under the Program

The Insurance Sector

105. *Technical Solvency Standards.* The implementation of a full Risk Based regulation that has been initiated, will still take a relatively long time before it becomes fully operative. Meanwhile, the Insurance Sector needs to be improved in terms of the capital requirements for insurers and reinsurers, the updating of the minimum solvency levels that they must meet, the basis for the establishment of the technical provisions that should be reflecting the liabilities arising from their insurance activity, and the type of assets that can be allocated for the coverage of these provisions.

106. *Capital Requirements.* Under the first loan, the financial system reform Law (No. 795/2003) modifies articles 80 and 82 of the "Estatuto Orgánico del Sistema Financiero (Financial Sector Framework Law)". The new Article 80 establishes that the minimum capital for an Insurance Company (except those operating export credit insurance and Reinsurers) has been set at 5.5 billion Pesos, and for a Reinsurer at 22 billion Pesos. These amounts will be automatically updated with the CPI. Article 82 defines the concepts of Technical Net Worth, Adequate Net Worth and the Guarantee Fund, and establishes that the required Net Worth to operate in each Line of business ("ramo") will be fixed by the Government and that these amounts should be added to the capital requirement of Article 80.

107. The Government, therefore, using its capacity and increased regulatory flexibility provided in Article 82, will proceed towards a prompt revision of the minimum capital (net worth), requirements for insurers and reinsurers. In doing so, the Government will allow consideration of both the local environment and the need to align these amounts with international standards for the different lines of business (property, life, accident). This revision affects not only to the minimum initial capital but also the solvency requirements for each line of business.

108. *Technical Reserves.* Law 795 has also modified Article 186 of the framework law, empowering the Government to establish the technical provisions that must be set by insurers. These provisions must be equal to at least: (a) the Unearned Premium Provision (still called Unexpired Risk Provision), (b) the Mathematical Provision, (c) the Pending Claims Provision and (d) the Claim Stabilization Provision. In a first phase, the Government will analyze which improvements can be introduced to the present regulation.

109. *Enforcement Regime.* In order to guarantee a proper fulfillment by insurers of the solvency and reserving requirements in the first stages of this reform, the SB will count on a schedule of sanctions for breaches of minimum solvency requirements or the adequate level of technical reserves. The SB's insurance supervision will also be extended local offices or agents of foreign insurance and reinsurance operations.

110. *Investment Norms.* Finally, in the area of investments of insurer's technical reserves, the Government is considering a policy proposal to establish a more flexible regime for the investment in assets permitted to fund the technical reserves so as to allow insurers to better match the maturity of their liabilities with corresponding investment assets. In that regard allowance might be made for the introduction of a certain proportion of real estate and loans as qualifying assets, although this should will be done with strict adherence to all the prudent principles that investment of these funds are subject to.

The Trust Industry

111. For the first operation under the program, the Government has implemented an initial set of reforms within the financial system reform law, in order to address business transparency and operational flexibility needs for the trust industry. A key concern of the authorities has been the diverse pricing practices of trust companies with respect to funds managed under either trust or asset administration contracts. Prior to the reform, the pricing of investment management services could have been based on either fixed commissions, asset based fees, return/yield based fees, or other modalities. In order to promote transparency and comparability for clients, the new financial system reform law requires that trust company fees for managed investment assets, be expressed as a percentage of the managed assets, and that fees be discounted from the fund. In this manner, pricing norms are normalized and comparability of products and transparency is assured for clients.

112. In terms of prudential risk management practices, the new financial system reform law replaces the previous limits on investment instruments regulated for the trust industry, with a requirement that trust companies establish their own internal investment risk management systems for reporting to the SB. Consistent with banking system practices being adopted in line with Basle II guidelines, the risk management models of trust companies for asset management functions, are also to be developed internally by the supervised institutions. These risk management systems, once developed by each firm, will be subject to review and no objection byf the SB. The new law therefore, avoids the prior practice of attempting to regulate investment norms for a multi-function and diverse industry, and instead migrates to a modernized framework based on the SB's evaluation of internal corporate systems.

The Second Operation under the Program – The Insurance Sector and the Non Banks

113. The program for the second operation is described below. The second operation would include actions and reforms to: (a) phase in new risk based solvency and capital adequacy norms, (b) establish norms for the calculation of technical reserves and mathematical provisions, (c) regulate the insurance supplied pension annuity market, (d) establish a more adequate framework regulating the use of catastrophe risk reserves and for the accounting for financial reinsurance contracts, (e) remove tax obstacles and product restrictions for trust companies, (f) modify pension sector regulations to permit increased investment flexibility and protect pensioner funds, and (g) implement value-at-risk regulatory methodologies for trust and pension companies. While the main thrust of the program is described below, the final policy agreements and specifics of implementation will be defined during the formal preparation of the second phase.

The Insurance Industry

114. Once a conclusion has been reached by the SB regarding the technical provisions to be established by insurers to better reflect their liabilities arising from their insurance activity, under the second loan, regulations will be issued updating the rules for the calculation of solvency margins, the unearned premium provision, technical reserves, mathematical provisions in the life insurance industry, technical discount rates, and pricing of products pertaining to the pensions/retirement annuity market.

115. A modification of the regulations regarding the accumulation and use of catastrophe reserves will be considered in order to allow their utilization for major events, with reserve replenishments achieved according to a graduated schedule. The accounting norms for reinsurance contracts will also be reviewed with a view to adjusting these to recognize financial (or finite) reinsurance treaties as contracts without having full risk transfer characteristics, regardless of their commercial names.

116. The introduction of the changes mentioned above will significantly reinforce the solvency of the insurance industry in Colombia and will allow a more gradual and phased implementation of the new risk based solvency regulations. The introduction of the SEARS approach will be rolled out in a manner consistent with the local progress of the industry and supervisors' actuarial and risk management capacities.

The Trust Industry

117. Under the second operation, certain regulations applied to the trust industry are expected to be examined. For example, the financial transactions tax may be applied more frequently to trust companies given their multiple routine transactions required during the transfer of funds. In addition, since trust companies currently have a sales tax applied on their commissions and fees, the reform will review this practice to make it consistent with practices in other parts of the financial industry.

118. An additional area that will be considered, is the level of capital requirements for trust companies. Current requirements are somewhat arbitrary given that trust companies effectively have no need for a solvency margin. In addition, the minimum requirement on the size of client funds to be invested for business by trust companies, will be reviewed. To support the development of internal risk management systems, regulatory circulars will be issued by the SB specifying value-at-risk (VAR) and duration gap methodologies to be applied by the trust industry to measure market risks.

The Pension Fund Industry

119. Under the second operation, prudential norms for the private pension fund industry will be upgraded and disseminated in line with those in the trust industry, so that AFPs follow appropriate VAR methodologies for assessing investment portfolio risks, and take measures to fully monitor their asset and liability duration gaps. Using these VAR methodologies as well as with calculations regarding the relative liquidity and secondary trading of securities, the benchmark/reference "synthetic" portfolio used by the SB to compute the minimum allowable rate of return of pension funds, will be reviewed to better reflect actual market investment opportunities in line with the tradability and liquidity of securities, which the existing synthetic portfolio does not take into account, and which diminishes its usefulness as a reference investment strategy. In order to diversify risk and protect the value of pension assets, the government will consider regulations permitting an increase in AFPs investment limit in foreign securities (currently AFPs invest under 10% of their portfolio in these).

E. The Capital Markets

Background

120. A comprehensive strategy for capital markets and financial intermediaries needs be developed. At present, there exists an excessive fragmentation in Colombia's financial markets. Capitalization of the stock market amounts to only 13 percent of GDP, one of the lowest for the more developed economies of the region. The integration of the three stock exchanges in Colombia will help to increase market liquidity. The new securities law, now under preparation will also help reduce obstacles into the issuance of securities by companies and provide incentives for capital market activity, such as providing the legal basis for developing securitized transactions, one of which has been recently implemented. To facilitate securitization, a standardized mortgage instrument needs to be created. The recent launching of a securitization firm now provides the legal and institutional mechanism to jump-start the securitized asset market, which should help promote longer-term securities backed by credit or other asset portfolios.

121. Accelerating the development to deepen the markets for securities, long-term debt and securitized assets and derivatives, and promoting an ordered development of the large institutional players in such markets -- including insurance companies, mutual funds, and pension funds -- constitutes an important alternative mechanism to facilitate the absorption of risks by market participants. The development of the market for corporate stocks and securities will lessen the reliance on banking intermediation, thereby reducing debt leverage and allowing macroeconomic and financial shocks to be directly absorbed by investors rather than debtors or financial intermediaries.

122. The government has continued to progressively and successfully develop the basis for a capital market, particularly through its government securities market. The institutionalization of market-making agents in the financial sector and the regular schedule of auctions implemented by the government has succeeded in creating a liquid and deep capital market in government paper. More recently, the government implemented short-term issues of bills and notes and longer-term bonds, so as to complete the maturities available on the government debt yield curve while providing a full range of risk-free benchmarks to support private market securities pricing. The addition of issues of short-term maturities (60 days to 180 days) will also help set the zero risk benchmark of the yield curve for short-term corporate paper. At the subsovereign level, the Bogotá District government recently began to issue municipal bonds on the fixed-income market, backed solely by the credit of the municipality–district.

The Government Reform Program – The Capital Markets

The First Operation under the Program

123. *Asset Valuation Standards.* As part of the first operation and prior to the approval of the new securities law, the government has taken steps to set strengthen the institutional and normative framework for the oversight and operation of the capital markets. Specifically, the government has instituted a common methodology for the valuation of assets in the securities market to ensure the mark-to-market norms are established and applied consistently across the banking, securities and other non banks sectors (e.g.: institutional investors). For this purpose, a working committee among the SV, the SB and the Central Bank has been established, and an asset valuation methodology has been developed and disseminated to the industry. Valuation

standards have been established for government (Treasury) securities, external debt securities, other public agency securities as well as private fixed income instruments.

124. *Cross Sectoral Consolidated Supervision.* Given the increased inter-linkages between banking and securities institutions including cross ownership ties, the government has considered it of utmost priority to ensure that the supervision of such related entities is conducted at the consolidated level. For this purpose, under the first operation, a four year inter-institutional agreement between the SB and the SV has been entered into in order to conduct joint supervisions of financial groups which include banking and securities enterprises. The supervision teams of both authorities, will thus jointly examine operations which fall under both their mandates, including mutual funds managed by trusts, bank trading desks, and affiliated financial services.

125. *Capital Requirements and Conflicts of Interest.* The operation of a sound capital market also relies on the strength and financial resilience of the key intermediaries in that market. For that purpose, under the first operation, the government will issue regulations governing the proprietary market positions as well as capital at risk and provisions against conflicts of interest, as applied to the securities brokerage and dealer industries. This will put in place a framework holding dealers and brokers accountable for the management of client funds and to ensure their fiduciary responsibilities in separating their strategies when managing own funds versus third party investments, including the requisite procedural fire walls to avoid illicit leveraging of client funds.

126. *Institutional Strengthening.* In order to carry out the above functions effectively, the Superintendency of Securities (SV) has carried out a reorganization by decree. This will create a new structure including a separate mutual funds division to oversee the multitude of funds modalities in Colombia and begin to develop a regulatory and supervisory framework consistent across the industry. Another division for intermediaries and markets will be created to primarily focus on the regulation of entrants into the securities market, as well as the regulation of those institutions needing to exit the market due to non compliance with prudential norms, solvency risk, or other factors. Finally, a separate supervision division will be created to focus exclusively on surveillance of the market and enforcement of regulations. In the above structure, the SV therefore, will be strategically placed to focus its attention in the key risk areas pertaining to the operation of the market.

The Second Operation under the Program – The Capital Markets

127. Under the second operation, described below, reforms for the capital markets would include: (a) a new Securities Law, (b) provisions and regulations established for corporate governance, securities issuance, sanctions regimes, professional/technical entry requirements and qualifications, regulation of investment banks, and securities trading infrastructure, (c) unification of regulation and treatment of fund managers in the mutual funds industry, (d) dematerialization and electronic custody of securities, and (e) modernization of the SV including implementation of market monitoring instruments.

128. While the main thrust of the program is further described below, the final policy agreements and specifics of implementation will be defined during the formal preparation of the second phase. Under the second loan, the Government intends to have finalized the new securities law and regulatory/institutional framework. The new securities law will address key issues which will reform the operation and behavior of market participants while promoting

additional issuance of securities through less onerous regulatory procedures. A number of key reforms under the law are considered:

129. The law will provide guidance and regulatory powers to the SV to establish industry entry criteria with respect to standards and qualifications of professionals in the securities industry including those working for securities firms, mutual fund managers, bank securities desk operators and other participants in the capital markets. The qualification and fit-and-proper aspect will be critical to ensure that industry entrants and players are fully trained and knowledgeable of market risks as well as governance and conflict of interest norms. Norms on corporate governance of public companies will be substantially reformed to increase transparency and accountability including definition of responsibilities of corporate Boards, management, legal counsel, auditors, and other de facto controlling interests in companies. In line with the supervision of the banking system's approach, the new securities law and associated regulations, will implement a sanctions and penalties regime within a graduated schedule of regulatory actions based on the magnitude of regulatory breaches by market participants.

130. *Mutual Funds.* A key aspect of the new securities framework will be the unification and consolidation of the mutual funds industry. The industry is segmented into various subsectors and the Banking Superintendency is responsible for supervision mutual funds managed by Trust companies even if such funds have similar or same characteristics of those managed by securities firms. In addition, the current regulation varies according to the type of fund (equities, fixed income, money market, venture, etc.) and thus supervision of the industry becomes inconsistent and cumbersome. As part of its market development mandate, the new law will also define licensing and regulatory requirements for the investment bank industry which is still very embryonic in Colombia. Investment banks can be important intermediaries and market makers in the securities market, and the new law will improve the definition of these agents so as to reduce regulatory ambiguity and encourage entrants into this market segment under transparent rules.

131. *Market Infrastructure.* Subsequent to the implementation of the law, the SV will also set and implement standards and operational procedures to modernize trading and electronic negotiation systems so as to increase the transparency and integrity of the price formation process as supported by the previously implemented asset valuation methodologies. The regulations under the new law will also implement the dematerialization of securities and the implementation of electronic custody registers so as to allow the more efficient purchase, sale, and ownership change in traded securities to be effected on an electronic book entry basis.

F. The Government Debt and Money Markets

Background

132. Over the last decade many substantive improvements have been made in the structure and processes of the local debt markets. The modernization of local debt markets and monetary policies as well as the primary issuance process, accelerated in 1997 and 1998. Over this period the authorities introduced the primary dealing arrangements, and the two tier on-line dealing system (SEN) for government securities was set up. The Central Bank (Banco de la República or BR) has also gone from being a very active issuer of its own paper to using indirect monetary instruments in implementation of monetary policy. Under the new model only the Ministry of Finance issues sovereign debt via fungible standardized issues. By 2002 the most liquid benchmark on the yield curve was represented by the 10 year 2012 maturity and the overall average modified duration of the treasury debt (TES B) was almost 2.5 years at past mid 2002.

133. At the outset of the modernization process, actions were also taken to improve liquidity in the money markets via actions to permit borrowing and lending of securities, the partial relaxation on taking short positions in the repurchase agreement market, and the subsequent complete liberalization via introduction of a new type of repo contract ("simultanea")[12]. Finally, over this same period important actions were taken with respect to the investment regulations applicable to forms of investment funds and pension and severance payment funds.

134. The debt market, however, despite implementation of these important steps, has experienced some set-backs in its development and exhibited a number of vulnerabilities. This was most recently illustrated by the mini-crisis in the TES market during August and September, 2002. The vulnerability witnessed in Colombia's debt markets in 2002, which eventually required the discontinuation of auctions of government bonds from mid August until the end of November 2002, highlighted the importance of implementing a mutually reinforcing set of reforms to reduce the reoccurrence of such scenarios. The 2002 vulnerability in the Colombian local debt markets was caused by a number of factors including:

- the transfer of interest rate risk to the private markets via issuance of government securities of long maturity and duration;
- the structure of the tax system which harmed liquidity, and contributed to rapid growth in the use of funds;
- structural factors in the debt market (e.g., public sector domination within the investor base) that limited liquidity and increased interest rate volatility;
- extensive fragmentation and segmentation in areas such as: the money markets, due to, e.g., differences in regulatory treatment of REPO contracts; in information transparency, lack of proper aggregation of information within and between trading platforms and in consolidation of information collected by different supervisory agencies. These problems hindered effective supervision, hurt the integrity of asset prices used in valuation, and harmed liquidity;
- an inadequate valuation and accounting framework that allowed losses to be hidden, and compromised the value of disclosures as a self-disciplining device;

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[12] In the Colombian market two types of repo's co-exist: a "*repo*" (which is a loan against collateral, with the collateral blocked at the level of the CSD) and a "*simultanea*" (which is a sale / buy back arrangement). When discussing repo markets in this document both instruments are covered unless explicitly stated.

- lack of an adequate risk management culture - in particular the capacity to measure and control market risks - by certain banking and non-banking entities; and
- gaps in regulations and supervision that hindered proper coordination, and slowed responses to the problems.

The Government Reform Program – The Government Debt and Money Markets

135. A credible reform package to address the vulnerabilities noted, involves three carefully sequenced areas for action: (i) debt market development, (ii) the money market, and (iii) a package of actions to improve risk measurement and management by various market participants. In the case of the first loan under the programmatic operation, emphasis will be on improving valuation and capital regulation while the second loan will focus on fundamental short to medium term actions aimed at addressing the vulnerabilities of the debt market and its participants.

The First Loan under the Programmatic Operation

136. Under the first loan of the programmatic operation, core actions will be taken in the following areas:

- measures aimed at increasing liquidity of Treasury securities;
- upgrading capital regulations for non-banks; and
- strengthening the valuation framework.

137. *Liquidity of Tes B (Treasury) securities*: The Tes B market has in general suffered from a lack of liquidity during periods of high volatility. While primary dealers have been required to "make the market", the obligations have been relatively light and not enforced. The Ministry of Finance has devised and issued a new set of Primary Dealer regulations which have strengthened obligations and the enforcement mechanisms (Resolución No. 001, 2003). Additionally, the Central Bank has changed its investment policy to allow it to purchase outright Tes B securities open for issue (so called on-the-run issues). This move is also expected to increase the liquidity and the associated liquidity premia for the on-the-run Tes Bs.

138. *Capital regulations for non-banks*: The authorities (in particular the Securities Superintendency or SV) are rapidly moving to strengthen the capital regulations and requirements for independent broker-dealers ("comisionistas") to limit the amount of leverage allowed by these entities, and to create incentives for better risk measurement and management. An important part of this effort is to harmonize capital regulation where possible, between entities regulated by the Banking Superintendency (SB) and the SV. However, such changes to capital regulations cannot prudently be introduced without consultations with the financial sector and with affected independent brokers in particular. The SV therefore, will issue a new set of capital regulations for broker/dealers with the aim of implementing the new capital regulatory framework after a brief consultation period. The authorities are also preparing an explicit transition plan for the phasing in of this new capital standard, which must be completed by December 2003.

139. *Valuation framework*: The lack of a solid valuation framework was identified as one of the most important factors adding to the vulnerability of the local debt markets, and the authorities have already progressed in this important area. The valuation methodology has been defined, and guidelines have been promulgated for valuation of all TES B instruments. Such securities by

far account for a dominant share of all outstanding securities in the financial system. The guidelines have been successfully implemented, and the integrity of the prices and methodology utilized, is monitored by the authorities in a collaborative process designed to ensure rapid consultation with regard to any anomalies in asset prices. The authorities are also establishing a high level valuation committee for this purpose. The committee will undertake such tasks as: periodically validate or review the methodologies used to determine prices, establish margins and reference rates; propose new methodologies that improve the accuracy of the valuation methodology; and recommend means by which the public and investors should be informed about the valuation methodology.

The Second Operation under the Program – The Government Debt and Money Markets

140. *The Second Phase.* Under the second operation, a number of reforms, described below, are anticipated. These include: (a) establishment of valuation guidelines for all securities, (b) setting out an issuance strategy as vetted by an established high level debt management committee, (c) implementing a new collateral system for central bank operations and taking measures to strengthen the efficiency of the repo market, (d) regulations to clarify the accounting treatment of forced investments in public securities taken by public agencies, and (e) establishing risk management VAR guidelines for institutional investors managing securities and fixed income funds. While the main thrust of the program is further described below, the final policy agreements and specifics of implementation will be defined during the formal preparation of the second phase. Under the second loan of the programmatic operation, core actions will be taken in the following areas:

- debt market development with special emphasis in the near term, on the definition of an operational debt issuance strategy;
- strengthening of the money market with special emphasis on the development of local repurchase agreements and treasury bill markets; and
- a package of actions to improve risk measurement and management by various market participants.

141. An essential building block to support risk measurement and management, is development of the money market. Instruments such as T-bills or CDs are the natural instruments to be held in the portfolios of money market mutual funds. The lack of money market development has been due in part, to the debt issuance strategy that has not focused adequately on development of the short term T-Bill market. In the near term, immediate priority will also be given to the development of the repurchase markets. In the medium term a new approach to the short-term T-bill market is warranted. There will be consideration to establish a revolving T-bill program of significant size in maturities on the short end of the yield curve. The next steps in promulgating an overall valuation methodology will include design of a valuation methodology for a broader cohort of securities. The authorities plan next to introduce valuation methods to be applied to other forms of public debt.

There is also a need to introduce a package of measures relating to the capital regime, risk management guidelines and reporting practices while continuing to strengthen and broaden the valuation framework. The SV started with the issuance of new capital regulations for independent broker dealers that corrects problems with the definition of capital and also imposes risk related capital requirements. This coupled with other changes in the regulatory framework, will also lead to improvements in the solvency of primary dealers and management of funds.

PART III. THE PROPOSED LOAN: A PROGRAMMATIC APPROACH

A. Loan Description: Objective and Rationale for Bank Involvement

142. *Loan Objective*. The objective of the loan is to complete the clean up of the banking system as a result of the 1999-2001 crisis and to strengthen the government's capacity to manage and mitigate weaknesses in the financial system. At the same time the objective is to prevent crisis contagion effects from neighboring countries or other exogenous events, by utilizing strong regulatory incentives for prudential management, market risk-sharing mechanisms and optimal supervisory powers to expeditiously contain any emerging risks in the financial system. The project also aims to strengthen and diversify the participation of the housing mortgage market as well as of non bank financial services and securities institutions in the financial system in order to implant a framework which provides more liquidity in the markets and diversifies the sources of finance for investors and actors in the real economy. At an institutional level, the objective will be to strengthen the capabilities and financial/supervisory institutions while strengthening the legislation to incorporate areas of corporate accountability, governance and risk management as key elements in the regulatory strategy.

143. A key aspect of the proposed program is the design of a two pronged effort to first dispose of the financial system's remaining loan assets (or collateral) remaining from the interventions during the earlier crisis by developing more agile and modern financial instruments and fiduciary arrangements to package assets according to credit rankings while making collateral liquidation procedures much more agile and effective. As part of this effort, the remaining intervened banks are expected to be divested and the largest second tier problem bank will be wound down. A second aspect is the development of a liquid securities market by, inter alia, modifying the framework for the mortgage sector to permit more standardization and allow securitization of loans as well as to reform the entire securities legislation to promote a more agile development of the local capital market while streamlining and adjusting the benchmarks and exposure risks of the government debt market as a key pillar to support the private fixed income securities market.

144. At the same time, the operation addresses the micro credit sector and promotes further credit access by permitting financial institutions to provide credit or leases to small financial entities so they can better fund their financial services to the micro sector. Finally, given the unique environment in Colombia, the above reforms are supported by specialized measures to detect money laundering activity associated with the drug trade or terrorist activity.

145. *Program Amount and Sequencing*. The program will consist of two operations, each of one loan. The first loan will be in the amount of US$150 million and the second one for US$150 million. All prior actions for the first operation have been undertaken at this time. Disbursement of the first loan will take place immediately following approval and compliance with standard effectiveness conditions of the Bank. Approval and disbursement of the second loan is expected to take place approximately a year hence, following completion of tangible implementation indicators and enforcement actions associated with the first loan as well as with conditions including approval of the pertinent legislative frameworks required under the second operation.

Rationale for Bank Involvement and Strategy

146. ***Relation to Country Assistance Strategy.*** The operation constitutes a main pillar in the Bank's Country Assistance Strategy (CAS) as delineated in the CAS document discussed on January 16, 2003 (Report No. 25129-CO dated December 24, 2002). The assistance strategy which relies on the government completing a number of structural changes supporting its economic growth, poverty reduction, and fiscal strategy, includes consolidating and extending the reforms of the financial sector to set the base for funding private sector led growth with sufficient regulatory and market incentives while assuring the solvency and proper governance framework of financial institutions.

147. Since current economic conditions preclude strong incentives for private bank lending, and thus financial access is very restricted, the financial sector strategy as envisioned in the CAS as part of the macroeconomic growth package of policies, includes strengthening the capital base of the banking system by removing unproductive financial assets through mergers, acquisitions, asset transfers and/or liquidations while aiming to modernize the funding instruments and institutions in the country's financial market so as to improve the liquidity of the savings base through the regulation and standardization of financial contracts under a diversified set of instruments (bank lending, micro lending, housing finance, securitization, fixed income and equities, insurance and trust services, and streamlining the government debt market). Since one of the main pillars of the CAS is to increase the role of the private sector in promoting growth, the development of the private financial industry while reducing the role of the State in the financial sector, constitutes a key part of the policy and institutional package with which to engender economic reactivation and facilitate the financing of new investment in Colombia.

148. ***Timing and Level of Financial Support.*** From a balance of payments and budgetary perspective, Colombia clearly requires external financing to meet its obligations given the net expected outflows of private lending during 2003 and 2004 ($1.1 billion and $1.7 billion respectively). At this juncture, Colombia's access to financing from the international private capital markets is quickly declining, and due to the fiscal situation, there are few reassignable funds to fill any gaps and meet debt servicing obligations. In 2003 total debt service as a share of exports of goods and services, is estimated at 49% versus 42% for 2002, and debt outstanding as a percentage of GDP was estimated at 55% in 2002 and projected at 56% for 2003 with the latter increase expected to be temporary, to be reversed. In addition, the 1999 banking crisis which required intervention by the State, generated direct fiscal costs amounting at the time to about 4% of GDP, as well as contingent liabilities which continue to be outstanding (approximately US$ 2 billion) due to intervened financial institutions which are still being resolved. The proposed program aims as well to implement modernized banking resolution tools which generate market sharing risk mechanisms such as sale and transfer of asset portfolios to the private sector, with the objective of reducing and eventually extinguishing those outstanding government liabilities.

149. Under the program period, GDP growth is projected to be 2.5% in 2003 and between 3.0% to 3.5% in 2004. The same time, the government's budget deficit is estimated between 2.5% - 3.0% of GDP in 2003 and is projected at between 2.0% - 2.5% of GDP for 2004. However, an eventual war in Iraq and/or a further escalation of violence in Colombia might make these projections on the high side. The budget balance would thus aim to remain at -2.5% or below from 2004 onwards under the IMF program, from an estimated -4.0% in 2002 and a target of under 3.0% in 2003. Monetary policy is expected to be modestly tight in order to maintain

inflation low between 4% and 8%, and to avoid any sharp changes in currency value which will remain on a very gradual depreciating path. The proposed loan would, through the more efficient mechanisms and legal provisions for the disposal, sale and/or liquidation of intervened bank assets and liabilities, aim to stem any further fiscal losses or potential liabilities of the State due to unresolved financial institutions, thus protecting social expenditures which target the poor and eventually attracting additional external financing and investment.

150. *Medium Term Objectives and Outcomes.* For the banking system, the Government's medium term goals are to ensure the stability and strength of the system so that it may return to a position where the provision of credit can be increased to support the reactivation of the economy, a key requirement in the success of the government's economic development program. Within this process, the government intends to simultaneously reduce its fiscal obligations and contingent liabilities which had emanated from the support it provided to financial institutions as well as its direct stake in the "officialized" banks which it needed to manage following earlier interventions. The reduction of these obligations would not only provide the government with additional "fiscal space" but also encourage the standardization of a new policy framework in which the private sector might share the risks inherent in the financial system.

151. The housing finance sector suffered considerably during the last crisis, as illustrated earlier. This resulted in the reduction of mortgage financing which was detrimental to potential homeowners who could have established a more solid economic base as well as to the financial institutions themselves who could no longer count on housing loan portfolios to intermediate and mobilize savings adequately. The government's main developmental objective is to revive the housing market by first ensuring the soundness of the mortgage banks and allowing that sector to expand the provision of credit through innovative intermediation mechanisms specified in the Financial System Reform Law. The Government understands that the asset base of the housing stock, when financed by solvent institutions, can constitute one of the most stable sources for mobilizing savings for further investment in the economy.

152. With the focus on the banking crisis in 1999, little attention was paid to the insurance sectors and the non banks. This sector mobilizes significant sums of savings and investments through the financial system but regulation to-date was not upgraded. In order to prevent any future risks which might emanate in the financial system, either from a lack of prudential investment and market risk management measures, or from unsound underwriting practices, the government has included the reform of this sector as part of overall financial system reform. This is also particularly critical given the ties within large financial groups which can cover the range of financial services under the same ownership.

153. Partially as a result of the 1999 banking crisis but also due to the low capitalization of the equity market in Colombia, the authorities consider it essential to develop the capital markets as a funding alternative and competitor to the traditional banking system. The diversification of funding intermediation mechanisms in the financial system will help reduce risks of concentration of assets and cyclical downturns in particular sub-sectors of the financial industry. In this regard the government's strategy in developing this market is linked to its policy of economic reactivation and to optimize funding sources to finance new industrial and enterprise investment.

154. The development of the government debt and money markets highly complements and supports the development of the private capital markets. The government recognizes the benchmarking role played by a structured and broad spectrum of government securities issues to

set both yield and maturity references for subsequent issuance of private sector fixed income securities. In this regard, while the government has already successfully developed a Treasury securities market, the irregular cycles of issuance and the lack of coverage of certain maturity segments of the yield curve has promoted demand for these particular instruments but has not engendered the issuance of private securities. The government considers it a priority to develop a systematic strategy for debt issuance in the domestic market and in the process, develop incentives including through enhancement of the local money market, for private corporations to offer debt instruments using reference prices.

155. ***Bank Role in the Medium Term Program.*** Under the banking component of the program, the support provided by the Bank involves developing norms that regulate transactions within large financial and economic groups and the risks such transactions may engender. Such a regulatory framework will also allow deployment mechanisms which exploit a range of financial instruments to allow the generation of structured financial packages designed for the disposal of balance sheets and asset transfers to interested buyers in the financial system. The latter mechanisms are also intended to efficiently reduce fiscal exposure to intervened institutions by avoiding lengthy State interventions and ongoing management of such entities.

156. Under the housing finance component of the program, the Bank will support the enhancement of the regulatory and risk management framework for the housing finance industry to ensure a sound development of the securitization market. Besides the implementation of soundly designed inflation/interest hedging mechanisms to assure the long term sustainability of this sector, the Bank will also support the implementation of legislation to provide banks and other financial institutions incentives and funding sources for offering non traditional credit and leasing instruments to promote the growth of the housing market.

157. For the insurance component of the program, the Bank will support the adequate monitoring of this industry's risks, particularly since these entities are heavily involved in the contractual savings sector, is crucial to ensure both the protection of assets forming part of the financial system's savings base, and to maintain the integrity of the domestic capital markets of which these institutions are important investors. In addition, the Bank has an interest in developing the insurance and non bank sector which, when prudently managed, provide financial services which greatly assist in cushioning and softening the impacts of financial or economic shocks.

158. For the capital market component of the program, the Bank will support the modernization of the securities law which will involve the careful design of an operating framework that engenders good governance, informational transparency, efficiency of procedures, and fit-and-proper criteria for industry participants. In addition, the automation of certain practices, such as the dematerialization of securities held in electronic custody, can significantly increase market activity by reducing frictional costs.

159. Besides the policy support provided under this operation, the Bank has already been involved through non lending services and technical assistance, in developing for the Government's debt management program and procedures for improving the market's operation. The Bank's policy support involves the development of a common valuation methodology for Treasury securities, consistent with the methodologies being developed for all traded securities. The Bank is also supporting the development of regulations pertaining to the rules of operation

of primary dealers in the government debt market, as well as adoption of regulations pertaining to proprietary capital/trading positions.

B. Program Conditionality

Conditions for Board Presentation / First Operation

160. The First Phase of the Program comprises a major reform effort geared towards strengthening private financial institutions, implementing measures to detect and correct developing weaknesses in the financial system, divesting assets of State owned banks, and initiating reforms in the capital markets and government debt sector. The main pillar of the First Phase reform effort in the program is the recently approved Financial System Reform Law (No. 795/2003) which covers a broad spectrum of changes in financial legislation, ranging from corporate governance norms to bank restructuring procedures to the insurance and housing finance sectors, as listed further below under the loan conditions. In this regard, the new Law sets much of the stage for this first phase given its depth of coverage, while laying the groundwork for a number of complementary supporting reforms which constitute the other elements of the first phase of the program including the sale of State owned banking assets, mechanisms to improve the operation of the mortgage markets and ensuring regulatory consistency between the banking and capital market industries.

161. ***Prior to Board Presentation***: The Government will have (i) taken the necessary steps to maintain a sound macroeconomic framework as certified by the IMF; (ii) approved major reforms to the financial system law, (iii) agreed to approve and implement an overall medium term economic reform program as indicated in the Letter of Development Policy; and (iv) carried out the specified regulatory and institutional reform actions as listed below:

Banking Regulation and Supervision

The Borrower has enacted Law 795-2003 to regulate, inter alia: (a) the independence of decision making by FIs' of boards of directors; (b) the enhancement of the existing code of conduct for managers and directors at FIs; (c) the integration of sanctions rules applicable to administrative officers, board directors and auditors at FIs; (d) the powers of SB to conduct supervision of consolidated financial groups including authority for SB to inspect companies in those financial groups not directly under its supervision; (e) the prevention of conflicts of interest related to the operations of FIs; (f) the enhancement of SB's mechanisms to intervene FIs and apply sanctions.

The Borrower, (a) through SB, has issued Circular Externa No. 046, dated October 29, 2002, which strengthens existing regulations that prevent money laundering in the Borrower's financial sector, and (b) through the enactment of Law 795-2003, regulates FIs' obligations to directly report information on financial cash transactions to MoF's anti money laundering monitoring unit.

Banking Resolution

The Borrower, through the enactment of Law 795-2003, has regulated (a) the compulsory procedures for asset and liability transfers and carve-outs from failing banking institutions; (b) FOGAFIN's issuance of guarantees backed with deposit insurance funds, and (c) FOGAFIN's powers for swapping bonds issued by the securitization trust, with FOGAFIN bonds.

The Borrower through MoF has issued a commitment letter to the Bank dated March 28, 2003, to undertake a stocktaking review of the Borrower's financial sector, including, inter alia, a review of: (a) the risks affecting weak banking institutions under low economic growth scenarios; (b) the banking sector's cash flow generation; (c) the Borrower's public debt securities held by commercial banks and the possible risks affecting said banks as holders of said debt securities; and (d) contingency plans to address any potential risks caused by internal and/or external factors affecting the financial sector.

The Borrower: (a) through IFI's shareholders assembly of January 27, 2003, has approved the transfer of IFI's selected assets and liabilities to BANCOLDEX; and (b) through CONPES Document Number 3214 dated January 9, 2003, has requested FOGAFIN to commence the privatization process of BANCAFE, and (c) through FOGAFIN has selected an investment firm that will carry out said privatization.

Housing Finance

The Borrower has: (a) enacted Law 794-2003 to, inter alia, streamline banking foreclosure related judicial proceedings, and therefore execute collateral in a timely manner; (b) through MoF has issued Decree No. 710 dated March 20, 2003, establishing procedures for finance companies to obtain financing from commercial banks so as to increase housing micro credit lending; (c) enacted Law 795-2003 to regulate (i) the increase of access to segments of the population with limited or no access to financial services with respect to housing micro credit, and (ii) the participation of banks in the housing lease market.

The Borrower, through: (a) FOGAFIN has issued operational guidelines for a new swap program to protect mortgage borrowers against the risks of inflation; and (b) the Central Bank has adopted and published on its web site, procedures for swapping of mortgage backed securities through the FRECH fund, in order to acquire more liquid treasury securities.

Insurance and Non Banks

The Borrower has enacted Law 795-2003 to regulate: (a) MoF's powers to establish solvency margins and technical reserve of the insurance industry, (b) the minimum capital requirements for insurers and reinsurers; and (c) MoF's powers to establish minimum capital requirements for the different business lines of insurance.

Capital Markets

(a) The Borrower, through SB, has issued Circular Number 033, dated August 2, 2002 to update and adjust market valuation regulations; (b) the Borrower, through SV, has issued Resolution Number 0550, dated August 2, 2002 to regulate a common securities and financial asset valuation methodology to unify market pricing norms; and (c) SB and SV have signed a memorandum of understanding dated November 13, 2002, to, inter alia, carry out a joint supervision and surveillance of FIs and securities brokers and dealers, in accordance with the procedures set forth therein.

Government Debt Markets

(a) The Central Bank's board has issued the procedures for said institution's purchase of on-the run securities (traded securities reflecting the series most recently issued); (b) the

Borrower, through MoF has issued Resolution Number 001, dated January 2, 2003, to regulate, inter alia, primary dealer operations; and (c) the Borrower, through SV, has issued Resolutions Number 0964 and 1047 dated December 13, 2002 and December 30, 2002, respectively, to regulate the valuation of domestic treasury securities.

162. *Implementation Benchmarks and Results Monitoring.* Conditionalities have been met under the *banking* component of the loan and include the approval of major reforms to the Financial System Law as indicated above. Following loan approval, the Bank will continue to monitor further progress and results in the implementation of these reforms to assure their consistency with the medium term objectives of the development program. In particular, the application of the norms to turn around deteriorating financial institutions, the application of the procedures for separating viable assets with matching deposits for purchase and assumption by third party banks, and the divestment or closure of State banks, will constitute key benchmarks and measurable results to assure reduction of fiscal exposure to this sector.

163. Conditions have been met under the *housing finance* component. Follow up monitoring in terms of this reform's impact and results on the micro credit sector, include examining the growth in access to credit from previously unbankable sectors and the growth in the homeowner housing stock as well as the increase in housing lease contracts with purchase options, spurred in part by the growth in the mortgage bond and securitization market to allow freeing up funds for lending.

164. Conditions under the *insurance* component have been met and include the legislation indicated earlier. Monitoring benchmarks for implementation of this component will include the behavior and/or consolidation of industry participants in line with their adaptation to the new capital regulatory requirements, the record of enforcement of such by the SB, as well as the level of development in actuarially based reserving practices for insurance liabilities. A strongly perceived insurance sector should also, along with projected economic growth, be reflected in the further expansion of the industry into the business and consumer sectors.

165. The principal actions specified as a conditions for *capital market* development have been met. The three financial authorities involved have set up a working committee to define the technical models to be used across the credit and securities industries. Monitoring of the execution of this framework involves the observation of market behavior to assure the removal of arbitrage based on variations n financial asset valuations, and a subsequent the increase in securities market activity which will subsequently be boosted by the passage of a new securities law.

166. The condition related to *public debt management* has been met. The valuation policy for treasury securities will improve primary and secondary market pricing and permit increased trading based on objective and technically modeled pricing criteria. The eventual adoption of similar methodologies for other fixed income securities will allow the market to expand through increased placements by private enterprises.

The Second Operation

167. *Prior to the Second Operation*: The second loan will be prepared and made available once the Government has (i) continued to maintain a sound macroeconomic framework per IMF certification, (ii) confirmed that all legislative and related reforms under the first operation remain in force; (iii) implemented all agreed follow up actions including application of a prompt

corrective actions regime with associated graduated sanctions, establishment of the new banking resolution and deposit insurance framework, (iv) effected initial reforms to strengthen the insurance sector; (v) undertaken actions related to completing the agenda in the housing finance and mortgage market sector, (vi) implemented a new Securities regulatory and institutional framework and (vii) other agreed activities including approval of risk management regulations for the insurance, trust and pensions industries, and the launch of a new government debt management policy.

168. For the *banking* component of the second phase, the loan will proceed based on specific actions demonstrating implementation progress from the first phase and policy initiatives which aim to institutionalize the new supervisory framework. Key actions related to the banking sector components will involve the enactment of the necessary decrees and regulations required to fully implement key provisions of the Financial System Reform Law, including those related to the supervision of financial conglomerates and related parties. Key actions for the second loan will also involve the issuance by the SB of procedures to ensure the consistent application of a regime of graduated sanctions and penalties for evoking corrective action on the part of supervised entities.

169. The *housing finance* component of the program will proceed based on progress achieved in improving the regulatory environment and reduction of risk in the mortgage market. In particular this will include demonstrable progress in areas such as upgrading of norms for the primary and secondary mortgage markets including, inter alia, harmonized capital adequacy regulations between securitization and credit institutions to avoid regulatory arbitrage.

170. The implementation of the second phase of the program under the *insurance* component, is intricately tied to progress in the application of the new framework established under the first phase. In this regard, key actions for the second phase will include the implementation of regulations for upgrading solvency standards, regulatory margins, and appropriate methodologies established to provision for insurance and market risks. For the other non bank financial institutions such as *trusts* and *pension funds*, the issuance of binding regulations specifying value at risk (VaR) and duration gap methodologies for invested funds, will constitute a key achievement to modernize the internal risk management practices of such intermediaries and better protect client funds.

171. Under the *securities* component, the second phase will proceed based on progress achieved in the production and implementation of the upgraded securities framework. The completion of a draft new Securities Law and its presentation to Congress constitutes a key trigger for the second phase. A key action, given the disperse regulation of the mutual funds industry will be the specification and implementation of a uniform regulatory and supervisory framework for the mutual and investment funds sector.

172. Actions associated with the government debt component under the second loan, will be the government's adoption of a new issuance strategy for *government debt*. The adoption of the strategy will signify the incorporation of the above referenced market enhancement measures including valuation, pricing and periodicity of issuance, in order to set a viable market benchmark for both the private and the public sector to better manage risks.

173. The identified triggers for the financial sector reforms under second loan are as follows:

Banking System

The Borrower through: (a) MoF has issued Decrees for implementing the financial system reform law and (b) SB has issued circulars and regulatory amendments to adapt existing regulations to the supervision of financial conglomerates and related parties.

The Borrower though the SB has demonstrated: (a) the application and enforcement of the Law 795-2003 via actions such as specifying and integrating in a sequenced manner, prompt corrective actions to be applied, and developing procedural handbooks specifying enforcement of remedial actions under a graduated regime of sanctions, and (b) the effectiveness and improvement of supervision via progress on benchmarks established under it's Strategic Plan, including the improvement of risk assessments made for financial institutions, the conducting of consolidated financial group examinations, and the investment of resources for SB's institutional strengthening.

The Borrower through MoF has undertaken a financial sector stability review to assess future banking system health using projections of: (a) the risks of weak banking institutions under low growth scenarios; (b) the banking sector's actual cash flows; (c) the government debt securities held by commercial banks and its possible risks to said banks; and (d) contingency plans to resolve any potential negative effects within said sector.

The Borrower through FOGAFIN, has undertaken progressive actions in the divestment/dismantling of insolvent State banks, and measures for selling off assets of said banks to the private sector.

Housing Finance

The Borrower though MoF, and with technical support from FOGAFIN and SB, has taken measures to increase the competitiveness, soundness, efficiency and transparency of the mortgage industry, and to improve the institutional set-up to support housing micro finance.

The Borrower through MoF has taken measures to ensure that secondary mortgage market regulations and practices are adjusted, including improved securitization methodologies to harmonize risk-based capital adequacy norms and oversight functions between banks and securitization companies.

Insurance Sector and Non-Banks

The Borrower through SB has demonstrated (a) significant progress in the implementation of new insurance regulations addressing solvency margin standards and methodologies to upgrade the calculation of technical and mathematical reserves, and (b) set forth regulatory methodologies for identifying Values-at-Risk in the pensions, trust and insurance industries' investment portfolios.

Capital Markets

The Borrower through SV, has implemented a new Securities regulatory and institutional framework covering, inter alia:
(a) Corporate governance norms including role of the Board, management, auditors, and other industry officials;
(b) Securities issuance norms and disclosure requirements including rationalized procedures

for issuance; and
(c) Qualification of standards for industry professionals and entrants.

The Borrower through the coordination between SV and SB, has harmonized the regulatory and supervisory framework for the mutual and investment funds industry -- trust institutions, specialized investment funds and mutual funds under different supervisory authorities are placed within a consistent framework.

The Borrower through SV has implemented valuation guidelines for a range of public securities and private fixed income instruments.

Government Debt Markets

The Borrower through MoF, has developed an issuance strategy for government debt developed through a coordinated effort comprising technical teams from the MoF regulatory units, the DGCP, and the Central Bank.

174. ***Expected Outcomes, Implementation Benchmarks and Follow Up.*** Following the second operation, the targeted outcomes in the *banking* sector will include a measurable reduction in fiscal liabilities from the resolution of insolvent entities. A quantifiable improvement in the financial health of the sector, under the assumption of no recession should be observed, as well as a verifiable record of corrective actions achieved through the SB's improved supervision and prudent application of a sanctions and penalties regime to reverse deficient financial and risk management practices. Monitoring of these results will proceed via the Bank's ongoing policy dialogue with the Government which began with a previous FSAL loan and an FSAP exercise as well as its ongoing involvement in a current financial technical assistance loan, and its expected continuation of non-lending advisory services in the area of banking supervision.

175. The Bank will monitor the implementation of key *housing finance* reforms, in particular examining the judicial effectiveness of new foreclosure rules for liquidating collateral, and the improved efficiency and competitiveness indicators of mortgage institutions. Access to credit by the micro sector of the economy will be a key indication of success in the reforms established through the financial system. The mainstreaming of the securitization industry will be closely monitored given its importance in supporting (a) the mortgage finance market, (b) instruments for resolution and asset carve outs of banks, and (c) its role in capital market and securities development. The Bank expects to continue collaboration and advisory work in this sector over the medium term, and is in the process of preparing a program of technical assistance to carry some of these measures through trust funded programs.

176. Expected results in the *insurance* sector after completion of the second phase will include the across-the-board upgrading of the solvency level (and some possible consolidation) of the insurance industry allowing improved market penetration prospects for the industry as a whole. Adoption of modernized actuarial modeling standards are expected to be verified. The entire non bank financial services sector including the trust industry and the pension funds will have adopted risk management practices to ensure both balance sheet hedging or direct contractual hedging against adverse market risks. The Bank is also involved in a preparation of a separate investment loan which contains a key insurance sector component and which will permit continued policy dialogue and follow up to monitor the implementation of these reforms.

177. A principal objective of the *capital markets* component will be an increasing size in the private equity and fixed income markets in Colombia, under the new prudential fit-and-proper operating rules and with a strengthened Securities Superintendency to ensure oversight over the industry. The resulting diversification of portfolios of institutional investors such as AFPs, insurance companies and trusts, would represent a healthy development in the financial system and allow the spreading of investments across a wider range of economic sectors. The Bank has had a traditional and long term dialogue with the securities authorities in Colombia, dating back to the implementation of an ongoing technical assistance loan and followed up by advisory missions by both the Bank and IFC. The Bank was also involved in consultations regarding the demutualization and unification of the stock exchanges in Colombia, and expects to continue the partnership with the government in these matters. This will allow the Bank to actively monitor implementation of the new securities law after the closure of the second phase of the project.

178. A key result of the *government debt* component following the execution of the second loan, will be the implementation of a regular issuance program for government securities spanning across all yield curve maturities, thus effectively representing a full government benchmark series. Results would include follow up placements of private fixed income instruments on the market as well as the reduction in pricing discrepancies across holders of government debt. The Bank has started a technical assistance service including the strengthening of government institutions responsible for debt management and issuance. In this respect, efforts are actively underway to obtain further budgets as well as grant funding to continue the policy dialogue and institutional strengthening efforts.

C. Disbursement and Auditing

179. Disbursement arrangements will follow the simplified procedures for SALs/SECALs. The Borrower will open an account in the Central Bank of Colombia. Once the Bank formally notifies the borrower that a tranche is available for withdrawal, the borrower may submit a withdrawal application so that the proceeds of the tranche are deposited by the Bank in this account to be used in accordance with the Loan Agreement. For the purposes of the Programmatic FSAL's disbursements and audits, the Government will open a specific deposit account, prior to furnishing the Bank with the first request for withdrawal from the loan account, and thereafter maintain in the Central Bank a dollar denominated account on terms and conditions satisfactory to the Bank. All withdrawals from the loan account will be deposited by the Bank into the deposit account which should operate at the Central Bank in a manner similar to a commercial bank account without requiring the opening of intermediary commercial bank accounts for this purpose.

180. The Bank will monitor and assess ex-post (through supervision missions with the government's concurrence) the use of the deposit account based on the Comptroller General's Audit Report, if this shall have been carried out. The Government undertakes that the proceeds of the loan will be used to finance only eligible expenditures based on an existing negative list for the loan. The Bank will thus reserve the right to request: (a) an audit of the deposit account conducted in accordance with appropriate auditing principles consistently applied, by independent auditors acceptable to the Bank; (b) receipt as soon as available, of a certified copy of the report of such audit; and (c) any other information concerning the deposit account and the audit.

D. Environmental Aspects

181. The Programmatic FSAL has no direct impact on the environment. For the purposes of Operational Directive 4.01, it has an environmental category of C, which does not require an environmental assessment. In terms of environmental considerations, there exists a process of collateral valuation used by the government and the private industry to value loan portfolios of banks in the process of being dissolved or sold in whole or in part to other institutions. Such valuation also applies to the sale of assets under foreclosure procedures, and takes into account as part of the prudential review of asset quality, existing environmental liabilities (e.g.: real property in flood zones, industrial property requiring environmental clean up) as part of the market valuation process for determining net value of such properties. While the process is based on market discounting to account for such liabilities, the Bank has communicated to the government the benefits of developing means for systematizing the environmental review process under such transactions to allow for identification of environmental issues as well as to ensure precision in the valuation of assets based on both real and financial factors.

E. Social Aspects and Poverty Impact

182. The program contains important elements of social protection for certain segments of the population. To begin with, the financial system law's reforms which affect the protection of depositors are aimed at providing full coverage of deposit losses for the smallest depositors in the event of bank failures. While the lowest income segments of the population may not always own bank deposits, other features in the law (see further below) would aim to increase the bankability of previously underserved segments of the population. With respect to deposit insurance reforms, previously all depositors needed to pay a coinsurance or deductible portion of their deposits when receiving compensation for funds lost through bank failures. The government, recognizing that the smallest depositors have little ability to monitor or correct bank risk taking, has authorized through the law, full coverage and reimbursement to those small depositors whose deposits fall within the specified insurance limit provided by the State. Thus, for the smallest depositors, they may receive full protection and compensation by the State.

183. Another social intervention via the financial system, is the new financial system law's allowance for commercial banks to fund credit lines for finance companies for the purpose of extending micro finance to the housing sector. The new law also permits banks to engage in micro housing credit operations. In addition, given the difficulty to finance housing without owning real or other collateral, the new law introduces the concept of housing leases to be offered by banks, and which would provide housing options to lower income families without the need for a down payment. The leases would have an option to purchase once the holder could accumulate funds to convert the contract into a mortgage. These policies are specifically aimed at providing increased access to credit to the underserved or non-bankable sectors of the population. In addition, reforms aimed at increasing the efficiency of banking operations , mitigating future risks of bank failure, and developing alternative financing sources in the capital markets, would indirectly benefit the poor avoiding the sudden withdrawal of weak financial institutions from given sectors or regions which inevitably leads to steep drops in community and business investments. Similarly, the enhancement of anti money laundering systems would help reduce contamination of the banking system with illicit funds which become volatile and do not serve as a reliable savings base for investment in community development, particularly in rural areas.

F. Benefits and Risks

184. ***Benefits.*** This proposed programmatic adjustment operation would have benefits in a number of areas of the financial system. The reformed legal framework would significantly upgrade and facilitate the regulation, corporate governance, and risk management of the financial system. The modernization of bank supervisory practices would cover the sequenced and early application of corrective actions and associated sanctions to halt accelerated deterioration of financial institutions and correct deficient management practices regarding operational practices and risk taking, as well as upgrading the Superintendency's monitoring tools for risk assessment, particularly for consolidated financial and industrial groups. It would increase the autonomy of the supervisory body to undertake such actions, upgrade the mechanisms available for resolution of intervened or insolvent banks so as to minimize potential drains on the public budget and permit quick liquidation and asset foreclosure procedures. The rationalization and consolidation of the state owned second tier lending banking sector will also reduce fiscal exposure and potential losses and generate additional market niches for the private banking system to develop.

185. The new framework will open up the financial market, under tight prudential rules, to allow diversification and improvement of products in the housing finance and mortgage market sector, including funding instruments for the micro credit sector, as well as in the capital markets, thus diversifying financial risks into other sub-sectors with capacity to raise financing and liquidity. The development of market hedges and swaps (interest rate and inflation based) will help the private sector contain such market risks and avoid balance sheet mismatches, while the increased and prudential design of securitizations will provide more liquidity in the fixed income market while developing structured instruments to transfer packaged portfolio risks to market investors, under pre defined credit risk categories. The upgrading of technology for the detection of money laundering will provide benefits of confidence and security of market players as well a detection capabilities for criminal prosecution. Finally, the rationalization and improvement of regulations in the non bank sector will increase investment flexibility in the insurance, pensions and trust industries as well as assure that their operations follow international standards for solvency adequacy.

186. ***Risks.*** One of the main risks to the reform program pertains to the possibility of adverse economic shocks which might be exogenously or regionally generated and which would set back the growth prospects for Colombia and thus compromise the long term health of the financial system which is just coming out of a tough period following the 1999 crisis. Political risks of legislative approval appear low since the Congress and the Administration are highly committed to the reform agenda for the financial sector. The Region though, is in a state of low growth with very few exceptions (e.g.: Peru, Mexico) and the current political and economic crisis in Venezuela, a country whose imports comprise about 15% of Colombia's export market, could easily generate a large gap in Colombia's economic recovery prospects if that market is lost.

187. A low or negative growth scenario for the next two years would not only threaten overall welfare, but could also reverse the gains in banking system health and generate the need for new contingency plans to rescue vulnerable institutions. To mitigate such risks or prepare for them, the government is committed to a floating exchange rate policy and maintain robust international reserves. Under the Operation, a condition to undertake a financial system vulnerability review exercise and the preparation of a contingency plan for addressing any materialization of such risks. The strengthening of banking resolution measures and asset carve out procedures managed by the deposit insurance agency will provide significant efficiencies in the quick disposal of

failing bank assets as well as avoid contagion as and unnecessary fiscal outlays. However, if the internal conflict situation and associated violence deteriorated, this would pose a significant risk of increasing fiscal costs as well as a slowdown in the reform effort, which could adversely affect the program.

188. Another risk pertains to the fiscal risk of over exposure, particularly to the internal capital market as well as the risk that international financial market access will remain difficult for a prolonged period. At the moment, the government debt market is growing and beginning to reach a level where it could potentially crowd out private financing and have an adverse effect on domestic interest rates. The Operation includes a comprehensive component to re-examine and upgrade the operations of the public debt market to ensure that it promotes rather than stifles the issuance of private sector securities. The commitment of multilateral institutions to fund the government's balance of payments and fiscal needs will to some extent mitigate the dangers of over exposing the government in the domestic financial market with shorter maturity debt instruments which could otherwise pose refinancing risks to the government as well or worse, forced roll over risks for financial institutions holding government debt. To further mitigate such a risk, and as agreed under the IMF Stand By arrangement, the government would consider utilizing resources in the petroleum stabilization fund on a temporary basis to avoid crowding out private debt.

189. Lastly, a key risk might involve the weakening of the government's resolve to conclude a full clean up of the remaining intervened private and public institutions in the financial system and which need to be disposed of efficiently. Instead, the government could potentially return to a regime of increased discretionality which would continue the process of State management, officialization of banks, and intensive supervision of such institutions (including any new ones should they arise), versus the program's approach of utilizing market and financial mechanisms to sell off such assets to the private sector utilizing more attractive securities instruments. This would imply the continuation and possibly the increase in fiscal contingent liabilities which would be detrimental for the maneuvering room the government may have if such liabilities materialize in the short term (e.g.: if asset values of intervened banks collapse and the government needed to proceed towards liquidation to recover State credits).

190. While such a risk could occur in the event of restructuring fatigue, lack of good market reception, or government perceptions that it might be more convenient to use straightforward traditional bank restructuring procedures, the risk is not considered high. One reason, is that the new financial system reform law, already approved gives priority towards using new restructuring tools which require the prompt carve outs and securitization of assets to sell off failed bank balance sheets. For those unrecoverable loans which require liquidation of collateral, the new reform (under the approved civil procedures code) also speeds up the judicial process very significantly and prevents earlier experienced delays in the realization of collateral to pay off residual creditors including the government. Another policy level mitigation factor is that the momentum, support and interest invested by the government in this new financial reform appears sufficiently robust and is seen by the authorities as a major advance in financial sector practices established to correct some of the problems experienced in the implementation of the prior reform. Hence, reverting to a less effective and less flexible approach, would be unlikely in the current policy environment, given the level of precision of the new reforms and the acceptance of them by the Congress.

COLOMBIA
FINANCIAL SECTOR ADJUSTMENT OPERATION
POLICY MATRIX FOR PROGRAMMATIC REFORM PROGRAM

Annex 1 - Policy Matrix

FIRST PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN - PRIOR ACTIONS TAKEN	SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN - FUTURE ACTIONS	KEY EXPECTED RESULTS AT THE END OF THE PROGRAM
MACROECONOMIC POLICY ENVIRONMENT ***Policy Objective***: Maintenance of a sound macroeconomic policy framework. Responsible Government Agency· MHCP		
The Borrower through MoF has maintained a sound macroeconomic program maintained with appropriate fiscal, monetary, inflation, reserves and exchange policies	The Borrower through MoF, has maintained a sound macroeconomic program maintained with appropriate fiscal, monetary, inflation and exchange policies	Reduction of fiscal deficit and reliance on long term debt financing, to increase stability
I. BANK REGULATION AND RESOLUTION		
IMPLEMENTATION OF THE REFORMED FINANCIAL SYSTEM LAW TO ENSURE SUSTAINABILITY OF THE FINANCIAL SYSTEM ***Policy Objective*** Upgrading the Banking Regulatory, Supervisory, and Institutional Framework Responsible Government Agencies MHCP, SB		
The Borrower has enacted Law 795-2003 to regulate, *inter alia*· (a) the independence of decision making by FIs' of boards of directors, (b) the enhancement of the existing code of conduct for managers and directors at FIs; (c) the integration of sanctions rules applicable to administrative officers, board directors and auditors at FIs, (d) the powers of SB to conduct supervision of consolidated financial groups including authority for SB to inspect companies in those financial groups not directly under its supervision, (e) the prevention of conflicts of interest related to the operations of FIs, (f) the enhancement of SB's mechanisms to intervene FIs and apply sanctions. The Borrower, (a) through SB, has issued *Circular Externa* No 046, dated October 29, 2002, which strengthens existing regulations that prevent money laundering in the Borrower's financial sector, and (b) through the enactment of Law 795-2003, regulates FIs' obligations to directly report information on financial cash transactions to MoF's anti money laundering monitoring unit	The Borrower through· (a) MoF has issued Decrees for implementing the financial reform law and (b) SB has issued circulars and regulatory amendments to adapt existing regulations to the supervision of financial conglomerates and related parties The Borrower though the SB has demonstrated (a) the application and enforcement of the Law 795-2003 via actions such as specifying and integrating in a sequenced manner, prompt corrective actions to be applied, and developing procedural handbooks specifying enforcement of remedial actions under a graduated regime of sanctions, and (b) the effectiveness and improvement of supervision via progress on benchmarks established under it's Strategic Plan, including the improvement of risk assessments made for financial institutions, the conducting of consolidated financial group examinations, and the investment of resources for SB's institutional strengthening	Banking stability and supporting financial and balance sheet strength indicators become evident Transparent and accountable identification and removal of conflicts of interest and related party risks is achieved. Evidence of their reduction within the financial system, is established via the SB's record of application of the new corporate governance regulations for the financial sector Application of the enhanced banking supervision powers is evidenced, permitting the early correction of adverse financial trends via the prompt application of sanctions and fines towards mismanaged and non complying financial institutions Graduated and intensifying process of sanctions provides evidence of institutional correction or dissolution of entities posing insolvency risk, thus reducing potential costs to the State Improved prudential practices increase the confidence and stability of the financial system, and permit managed risk taking, allowing channeling of increased credit into the economy. Detection of illicit financial activities and cash flows becomes more successful as regulatory, market monitoring systems, and technology, are improved

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IMPLEMENTATION OF THE REFORMED FINANCIAL SYSTEM LAW FOR IMPROVING EFFECTIVENESS OF BANKING RESOLUTION PROCEDURES *Policy Objective* Upgrading the Bank Resolution and Deposit Insurance Operational Framework Responsible Government Agencies. MHCP, FOGAFIN		
The Borrower, through the enactment of Law 795-2003, has regulated (a) the compulsory procedures for asset and liability transfers and carve-outs from failing banking institutions, (b) FOGAFIN's issuance of guarantees backed with deposit insurance funds, and (c) FOGAFIN's powers for swapping bonds issued by the securitization trust, with FOGAFIN bonds The Borrower through MoF has issued a commitment letter to the Bank dated March 28, 2003, to undertake a stocktaking review of the Borrower's financial sector, including, *inter alia*, a review of (a) the risks affecting weak banking institutions under low economic growth scenarios, (b) the banking sector's cash flow generation, (c) the Borrower's public debt securities held by commercial banks and the possible risks affecting said banks as holders of said debt securities, and (d) contingency plans to address any potential risks caused by internal and/or external factors affecting the financial sector	The Borrower through MoF has undertaken a financial sector stability review to assess future banking system health using projections of (a) the risks affecting weak banking institutions under low economic growth scenarios, (b) the banking sector's cash flow generation, (c) the Borrower's public debt securities held by commercial banks and the possible risks affecting said banks as holders of said debt securities, and (d) contingency plans to address any potential risks caused by internal and/or external factors affecting the financial sector	Reduction of fiscal liabilities and State interests in intervened financial institutions is achieved via the sale of their assets and matching liabilities through the new securitization/trust mechanisms Evidence exists of failed banks' viable assets/balance sheets successfully transferred to private sector institutional buyers. Increased banking strength and liquidity of the remaining solid banks, permit the provision of credit to an increased number of productive enterprises with cash flow prospects
The Borrower (a) through IFI's shareholders assembly of January 27, 2003, has approved the transfer of IFI's selected assets and liabilities to BANCOLDEX, and (b) through CONPES Document Number 3214 dated January 9, 2003, has requested FOGAFIN to commence the privatization process of BANCAFE, and (c) through FOGAFIN has selected an investment firm that will carry out said privatization.	The Borrower through FOGAFIN, has undertaken progressive actions in the divestment/dismantling of insolvent State banks, and measures for selling off assets of said banks to the private sector	Evidence, if liquidation of banks is required, that all small depositors covered under the insurance threshold limit are fully paid out and their balances are protected Premiums charged to financial institutions by the State for deposit insurance, are applied based on the risk categorization of banks established by the SB The divestment, merger and liquidation of the remaining insolvent State-owned banks has been completed, and fiscal contingent liabilities in this respect have been reduced substantially or fully eliminated
II. HOUSING FINANCE		
STRENGTHENING THE HOUSING FINANCE SECTOR AND EXPANSION OF THE MORTGAGE MARKET *Policy Objective* Upgrading the Regulatory/Operational Framework of the Mortgage Market and Improving Access to Credit Responsible Government Agencies. MHCP, FOGAFIN		
The Borrower has: (a) enacted Law 794-2003 to, *inter alia*, streamline banking foreclosure related judicial proceedings, and therefore execute collateral in a timely manner, (b) through MoF has issued Decree No 710 dated March 20, 2003, establishing procedures for finance companies to obtain financing from commercial banks so as to increase housing micro credit lending, (c) enacted Law 795-2003 to regulate (i) the increase of access to segments of the population with limited or no access to financial services with respect to housing micro credit, and (ii) the participation of	The Borrower though FOGAFIN, SV and SB, has taken measures to increase the competitiveness, soundness, efficiency and transparency of the mortgage industry, and to improve the institutional set-up to support housing micro finance	New judicial procedures show evidence of fast and efficient sale of loan collateral assets, allowing increased private market participation in the absorption of assets of failed financial institutions, and prompt payment of creditors Increased access to housing credit evidenced by underserved segments of the population The production of mortgage loans has expanded and lending margins reduced The

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banks in the housing lease market. The Borrower, through (a) FOGAFIN has issued operational guidelines for a new swap program to protect mortgage borrowers against the risks of inflation, and (b) the Central Bank has adopted and published on its web site, procedures for swapping of mortgage backed securities through the FRECH fund, in order to acquire more liquid treasury securities	 The Borrower through SV and SB has taken measures to ensure that secondary mortgage market regulations and practices are adjusted, including improved securitization methodologies to harmonize risk-based capital adequacy norms and oversight functions between banks and securitization companies	micro housing finance market applied to housing has expanded including housing leasing contracts. Mortgage bonds and mortgage backed securities develop with sufficient liquidity as a sustainable funding tool without undue regulatory arbitrage and/or tax privileges after the medium term market development period. A package of public policy tools to augment the housing finance market (e g interest rate hedge, inflation swap, mortgage security guarantees, rationalization of tax exemptions) improves the operation, risk management and ongoing sustainable development of the primary and secondary mortgage markets
III. NON-BANK FINANCIAL INSTITUTIONS (INSURANCE, PENSIONS, TRUSTS)		
STRENGTHENING REGULATORY FRAMEWORK AND FINANCIAL SOUNDNESS OF THE INSURANCE, TRUSTS, AND PENSION INDUSTRIES ***Policy Objective*** Upgrading the Regulatory Framework for Risk Management and Capital Adequacy of the Non Bank Financial Service Institutions **Responsible Government Agencies: MHCP, SB**		
The Borrower has enacted Law 795-2003 to regulate: (a) MoF's powers to establish solvency margins and technical reserve of the insurance industry, (b) the minimum capital requirements for insurers and reinsurers, and (c) MoF's powers to establish minimum capital requirements for the different business lines of insurance	The Borrower through SB has demonstrated (a) significant progress in the implementation of new insurance regulations addressing solvency margin standards and methodologies to upgrade the calculation of technical and mathematical reserves, and (b) set forth regulatory methodologies for identifying Values-at-Risk in the pensions, trust and insurance industries' investment portfolios	The solvency of the insurance industry is confirmed with respect to international standards, and the viability and actuarial soundness of the industry is established for the risk underwriting business Corporations and households increasingly rely on insurance coverage for personal and property risks. Insurance companies which only collect premiums and commissions but have no solid actuarial solvency or risk management culture, either adapt to the new norms and capitalize adequately, or are consolidated and removed from the market by the regulatory authorities. Pension, trust and insurance companies are adequately hedged and capitalized, and have improved corporate policies to ensure their provision against financial market risks, thus guaranteeing improved protection of client assets, reduction of liabilities for the State, and expansion of the client industry base

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IV. CAPITAL MARKETS		
MODERNIZING THE LEGISLATIVE FRAMEWORK FOR THE SECURITIES MARKET ***Policy Objective*** Upgrading the Regulatory Framework for the Governance, Transparency, Operations and Liquidity of the Securities Market Responsible Government Agencies· MHCP, SV		
(a) The Borrower, through SB, has issued Circular Number 033, dated August 2, 2002 to update and adjust market valuation regulations, (b) the Borrower, through SV, has issued Resolution Number 0550, dated August 2, 2002 to regulate a common securities and financial asset valuation methodology to unify market pricing norms, and (c) SB and SV have signed a memorandum of understanding dated November 13, 2002, to, *inter alia*, carry out a joint supervision and surveillance of FIs and securities brokers and dealers, in accordance with the procedures set forth therein.	The Borrower through SV, has implemented a new Securities regulatory and institutional framework covering, inter alia. (a) Corporate governance norms including role of the Board, management, auditors, and other industry officials, (b) Securities issuance norms and disclosure requirements including rationalized procedures for issuance; and (c) Qualification of standards for industry professionals and entrants The Borrower through the coordination between SV and SB, has harmonized the regulatory and supervisory framework for the mutual and investment funds industry -- trust institutions, specialized investment funds and mutual funds under different supervisory authorities are placed within a consistent framework The Borrower through SV has implemented valuation guidelines for a range of public securities and private fixed income instruments	Increased issuances of securities on the capital markets and purchases of securities by investors are evident in the expansion of the capital market, supported by improved rules of disclosure, corporate governance, professional qualification of industry participants, and improved securities industry trading infrastructure. The funds industry (including mutual funds) and its enhanced risk management practices, has developed, with increased participation by consumers and investors, based on the implementation of consistent regulatory, valuation and pricing norms across the sub-sector.
V. THE GOVERNMENT DEBT AND MONEY MARKETS		
UPGRADING THE POLICY AND OPERATIONAL FRAMEWORK FOR THE GOVERNMENT SECURITIES MARKET ***Policy Objective*** Implementation of a Public Debt Issuance Strategy to Improve the Functioning of the Fixed Income Market Responsible Government Agencies· DGCP, SV, BR		
(a) The Central Bank's board has issued the procedures for said institution's purchase of on-the run securities (traded securities reflecting the series most recently issued), (b) the Borrower, through MoF has issued Resolution Number 001, dated January 2, 2003, to regulate, *inter alia*, primary dealer operations; and (c) the Borrower, through SV, has issued Resolutions Number 0964 and 1047 dated December 13, 2002 and December 30, 2002, respectively, to regulate the valuation of domestic treasury securities	The Borrower through MoF, has developed an issuance strategy for government debt developed through a coordinated effort comprising technical teams from the MoF regulatory units, the DGCP, and the Central Bank	A regular issuance program for government securities is implemented spanning across the yield curve spectrum, thus engendering the increased issuance of private sector fixed income securities which use the government market as a benchmark. The size and depth of the capital market is improved, thus increasing alternative funding sources for businesses and corporations

Annex 2

LETTER OF SECTORAL DEVELOPMENT POLICY
Carta de Política de Desarrollo para el Sector Financiero

Bogotá, Marzo 18 de 2003

Señor
James D. Wolfensohn
Presidente
Banco Mundial
Washington, DC

Estimado Señor Wolfensohn:

Uno de los pilares fundamentales de la estrategia de recuperación y crecimiento económico del Gobierno del Presidente Uribe, consiste en la implementación de políticas y medidas dirigidas a fortalecer el sistema financiero nacional y garantizar su salud y sostenibilidad.

Un primer esfuerzo en la implementación de políticas y medidas en esta área se logró como resultado del primer programa sectorial de Desarrollo para el Sector Financiero del Banco Mundial. Continuar promoviendo el desarrollo del sistema financiero a través del fortalecimiento de la regulación, supervisión y esquemas de resolución de entidades; a través de la creación de nuevos mecanismos para la financiación de vivienda; y mediante el apoyo al desarrollo del mercado de valores y de deuda pública es hoy un compromiso de Gobierno.

Estas acciones van en la dirección de apoyar otras reformas estructurales prioritarias para el Gobierno y cuyo fin último es la construcción de un Estado Comunitario. Un Estado con autoridad legítima al servicio de la ciudadanía, que concentra sus esfuerzos en la seguridad para todos, la erradicación de la pobreza, el crecimiento y la búsqueda de la equidad. Un Estado que conlleve la responsabilidad política de la participación ciudadana en la definición de tareas, ejecución y supervisión de las mismas.

Sabemos que la implementación de muchas de estas acciones implica riesgos, pero el Gobierno ha identificado medidas de contingencia diseñadas para salvaguardar su programa y alcanzar el fin último, dotar a todos los colombianos de las oportunidades que les brindará una economía sana.

A continuación nos permitimos presentarle en el documento anexo una breve exposición de la situación económica del país y del sector financiero y, en ese contexto, una síntesis de los objetivos y el contenido de las políticas y reformas que se han emprendido para promover el desarrollo y fortalecimiento de la economía en general y del sector financiero en particular.

El Gobierno ve con beneplácito el acompañamiento y el apoyo financiero del Banco Mundial y, en atención a las medidas tomadas e implementadas, el Gobierno agradece la pronta consideración por parte del Directorio del Banco del primer crédito programático de ajuste al Sector Financiero contemplado en el CAS para Colombia para el período 2003-2006. El Gobierno está a disposición de los equipos técnicos del Banco para definir conjuntamente programas futuros de crédito en la medida en que se consoliden los ajustes y se requieran nuevas acciones en este sector.

Cordialmente,

/ original signed /

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Ministro de Hacienda y Crédito Público

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Departamento Nacional de Planeación

REPUBLICA DE COLOMBIA

MINISTERIO DE HACIENDA Y CREDITO PUBLICO
DEPARTAMENTO NACIONAL DE PLANEACION

CARTA DE POLITICA DE DESARROLLO PARA EL SECTOR FINANCIERO

Bogotá, 18 de marzo de 2003.

I. SITUACIÓN MACROECONÓMICA

CONTEXTO

1. Desde 1999 Colombia ha reducido los desequilibrios macroeconómicos que amenazaban con quebrar el crecimiento económico y el progreso social. La consolidación fiscal avanzó, la inflación se redujo y la estabilidad financiera se restauró. Esto a pesar de la agudización de la violencia y de la existencia de un entorno internacional adverso.

2. Sin embargo, el panorama actual del Estado colombiano es preocupante: recientemente el crecimiento de la economía se desaceleró, el problema de inseguridad se acentuó, el detrimento de los indicadores sociales se hizo evidente, el estado de las finanzas públicas se deterioró dado el creciente gasto público y la legitimidad del Estado se lesionó por el efecto perverso de la corrupción y el clientelismo. Siendo la recuperación económica y la seguridad interna un tema prioritario del Gobierno, la administración Uribe-Velez está comprometida con la consolidación fiscal y con reformas estructurales necesarias para llevar a cabo cambios que permitan que todos los colombianos se beneficien de las oportunidades que una economía sana les brindará.

DESEMPEÑO RECIENTE

3. Hasta comienzos del año 2002, los logros alcanzados en materia económica permitieron el acceso a los mercados internacionales de crédito y garantizaron la estabilidad de la tasa de cambio. Sin embargo, a mediados de 2002, el país sufrió las consecuencias de la inestabilidad regional: los spreads de los bonos soberanos se ampliaron de manera considerable y el peso se devaluó consecuentemente. Esta situación se vio agravada por el aumento en el déficit fiscal y por una agudización sin precedentes recientes en el conflicto armado. La agudización del conflicto no sólo ha aumentado la fuga de capitales y cerebros, sino que también ha disminuido la productividad de la economía y la inversión privada.

4. Enfrentado un entorno regional adverso e ingentes problemas fiscales, el nuevo Gobierno actuó rápidamente. Primero, propuso (y logró aprobar) importantes recortes presupuestales para el año 2003 hasta el punto de que el gasto diferente a intereses crecerá este año por debajo de la inflación esperada. Segundo, estableció un impuesto por una sola vez al patrimonio y presentó al Congreso un paquete de medidas tributarias y de control de gasto sin precedentes. Y tercero, expidió decretos que recortaban gastos, prestaciones o subsidios: se redujo a cero la tasa para el Certificado de Reembolso Tributario (CERT), las prestaciones extralegales a nivel territorial y se suprimieron las vacantes que no habían sido llenadas desde julio de 2002. De manera paralela, el Gobierno comenzó el diseño y la implantación de un ambicioso programa para reducir y reestructurar la administración pública.

5. Por otro lado, el sistema financiero ha continuado su recuperación desde la crisis de 1999, pero algunas debilidades subsisten. El entorno en el que operan los bancos se ha fortalecido significativamente con la adopción de regulación prudencial consistente con las mejores prácticas internacionales. La supervisión ha mejorado sustancialmente con la continua revisión e implementación de planes de recuperación para instituciones débiles, coordinación más estrecha

entre las autoridades de supervisión y la adopción de regulaciones que permitan acciones correctivas rápidas. Los mecanismos de apoyo y fortalecimiento patrimonial han sido firmemente establecidos por el Fondo de Garantías de Instituciones Financieras, FOGAFIN.

6. La reciente Ley de Reforma Financiera aprobada recientemente en el Congreso (Ley 795 de 2003) coloca el marco regulatorio del sector al nivel de los estándares internacionales de regulación y supervisión bancaria. La reforma financiera enfatiza el desarrollo de mecanismos que permitan modernizar algunos aspectos de la legislación vigente y flexibilizar rigideces de la normatividad actual, corregir debilidades evidenciadas en el proceso de reacomodamiento del sector financiero, introducir mecanismos de protección a los usuarios del sistema, implementar nuevos instrumentos para proteger la confianza del público en las entidades financieras y adecuar algunas normas a pronunciamientos de la rama jurisdiccional.

DESEMPEÑO MACROECONOMICO Y PERSPECTIVAS

7. Durante el 2002, el crecimiento real del PIB estuvo cerca de 1.7%, la inflación fue de 6.99%, el déficit en la cuenta corriente permaneció en niveles cercanos al 2.2% del PIB y las Reservas Internacionales Netas crecieron en un monto aproximado de US$ 220 millones.

8. Por el lado fiscal, al finalizar el año 2002, el déficit consolidado fue de 4% del PIB, 1,4 puntos por encima de la meta inicialmente pactada con el Fondo Monetario Internacional. Esta desviación se explica, en buena medida, por las mayores erogaciones (asociadas en parte al proceso electoral) y por la desaceleración del crecimiento económico en 2001 y en el primer semestre de 2002, la cual afectó de manera adversa el recaudo tributario.

9. El escenario macroeconómico para los próximo cuatro años parte de un déficit en la cuenta corriente que oscila entre 1% y 2,5% del PIB, una tasa de inversión que pasa de 13,7% a 14,6% del PIB; en consecuencia la tasa de ahorro doméstico aumenta de 11,9% a 12,6% del PIB. De esta forma, la financiación de la cuenta de capitales se explicará por el monto de inversión extranjera directa y el endeudamiento neto del sector privado y público.

10. Por otra parte, el sector privado adelantará un ajuste en el balance ahorro e inversión que oscila entre 0,2% y 1,6% del PIB como resultado de la recuperación de la inversión privada. El ajuste privado es necesario para hacer viable el ajuste público . Tanto la inversión extranjera directa como el financiamiento externo neto del sector privado financiarán el déficit externo en cuenta corriente, lo cual en la práctica significa que el sector privado tendrá un importante rol en el financiamiento de la inversión que se ejecute durante el siguiente cuatrienio.

11. El balance del sector público muestra un déficit que es financiado con recursos de crédito interno (entre 2,1% y 1,7% del PIB) y crédito externo (entre 0,3% y 0,4% del PIB). La gradualidad del ajuste sobre el exceso de gasto que subsiste en el sector público se financiará con el ahorro generado por el ajuste del sector privado. La credibilidad del ajuste en el sector público está dada por el alcance de las reformas estructurales que se están adelantando.

12. La consolidación fiscal continuará en el mediano plazo. Se espera que las condiciones económicas mejoren en 2004 y que el crecimiento real del PIB sea superior al 3 por ciento a partir de este año. El mayor déficit sería financiado con inversión directa, el continuo apoyo de la banca multilateral, y el acceso a los mercados financieros internacionales. La política monetaria

estará dirigida a apoyar una moderada reducción en la inflación dentro de un esquema de inflación objetivo y tasa de cambio flotante.

13. El déficit del sector público se reducirá a 2,1 por ciento del PIB en 2004, apoyado por las medidas expuestas anteriormente. El ajuste reducirá la deuda del sector público no financiero por debajo del 50 por ciento del PIB. El Gobierno espera que la sostenida reducción de la deuda, la continua mejoría en los indicadores de vulnerabilidad económica y el sólido manejo económico incrementen la confianza y permitan que la calificación crediticia de Colombia mejore y el costo del endeudamiento disminuya.

14. Se tiene como objetivo explícito reducir el déficit del sector público consolidado de 3,6% del PIB en 2002 a 2,5% en 2003, y continuar la consolidación del proceso en los años siguientes. El ajuste fiscal aumentará el superávit primario del sector público no financiero de 0,7% del PIB a 3,0%.

REFORMAS ESTRUCTURALES

15. Para continuar con la senda de crecimiento y estabilidad macroeconómica, el programa de Gobierno esta diseñado para incrementar los ingresos fiscales, reducir el gasto público, atacar la corrupción, apoyar la recuperación económica y el desarrollo social mediante una mejor distribución del ingreso, los servicios sociales y las oportunidades. Por ello el programa hace énfasis en el tema fiscal con el fin de retomar la senda de consolidación fiscal en el año 2003. La acción fiscal y una agenda estructural sólida permitirán que estos objetivos se alcancen dentro de un ambiente de estabilidad macroeconómica, apoyado por políticas monetarias prudentes y el fortalecimiento del sistema financiero.

16. Un elemento central del programa de Gobierno es el fortalecimiento de las finanzas públicas que busca reducir el déficit del sector público consolidado. Para alcanzar este objetivo se están adelantando acciones tendientes a congelar el gasto corriente del sector público y a implementar las medidas tributarias recogidas en la reforma tributaria aprobada recientemente por el Congreso; ambas acciones se complementaran con reformas estructurales de gran alcance como la reforma pensional de segunda generación y la reestructuración y disminución del tamaño del Estado.

17. Por otro lado, la política monetaria continuará siendo desarrollada dentro de un esquema de inflación objetivo con un régimen de tasa de cambio flotante. Igualmente, el Gobierno continuará con su política de fortalecimiento del sistema financiero, no sólo a través de la expedición de una adecuada regulación del sector financiero y del mercado de capitales sino del fortalecimiento de los esquemas de supervisión. Estas acciones se complementarán con acciones de política para mejorar las condiciones laborales de los empleados colombianos, de educación y salud que permita que más colombianos accedan a servicios educativos y sanitarios, de protección social para atender sectores desprotegidos de la población, de anticorrupción para mejorar la transparencia del sector público, entre otros aspectos.

18. Como complemento a las anteriores medidas el Gobierno ha puesto en marcha una estrategia integral que le permitirá brindar seguridad a todos los sectores de la sociedad, consolidar la presencia del Estado en el territorio nacional y recuperar el control en las zonas con

influencia de los grupos armados ilegales. La Seguridad Democrática es un elemento vital para la recuperación de la confianza y, por ende, para el crecimiento económico.

19. La estrategia de asistencia del Banco Mundial para Colombia, para los próximos cuatro años, será importante para adelantar reformas económicas y sociales que contribuyan a aliviar la situación de pobreza de la población vulnerable y a lograr la recuperación y sostenibilidad de los niveles de crecimiento económico.

PROGRAMA STAND-BY CON EL FONDO MONETARIO INTERNACIONAL

20. Dentro del marco de política macroeconómica, el Gobierno colombiano firmó un acuerdo Stand-By (SBA) con el FMI por DEG 1.548 millones para los siguientes dos años. Uno de los principales objetivos del programa es la reducción del déficit fiscal en dos puntos del PIB. Esta reducción se logrará con mayores ingresos tributarios, como resultado de nueva reforma tributaria y con la congelación de los gastos corrientes de la Nación por un período de dos años. En el mediano plazo, reformas estructurales como la Reforma Pensional -aprobada recientemente por el Congreso- y el programa de modernización del Estado, contribuirán a asegurar la sostenibilidad de la deuda y consolidar el proceso de ajuste iniciado por el Gobierno. El SBA incluye un déficit del sector público no financiero de 2.5% del PIB, un déficit de cuenta corriente de 0.8% del PIB y tasa de inflación entre 5 y 6% como principales metas para el 2003.

III. EL PROGRAMA DE APOYO AL SECTOR FINANCIERO

CONTEXTO

21. En 1998 el sistema financiero se encontraba en estado de crisis. En el ámbito interno algunos factores macroeconómicos afectaron el sistema financiero, propiciando el ambiente que llevó al desarrollo de la crisis financiera. A estos factores se sumó una fuerte expansión del crédito, en los primeros años de la década pasada, que llevó a un incremento del índice de cartera en mora y de bienes recibidos en dación en pago, afectando la liquidez y posteriormente la solvencia de las instituciones. El sector cooperativo, por su parte, estaba sumido en una crisis de confianza que hicieron evidente la debilidad estructural del sistema cooperativo.

22. En razón a esta situación y con el fin de evitar una crisis financiera generalizada, con efectos negativos sobre la actividad económica, el Gobierno Nacional adoptó medidas orientadas a desarrollar operaciones de apoyo, con el concurso de FOGAFIN, y coordinó medidas con la Junta Directiva del Banco de la República para dotar de liquidez a las entidades financieras. Gracias a estas acciones el sistema financiero mostró claros síntomas de recuperación; se redujo el riesgo sistémico en el sector y se evitó la propagación de la crisis. Sin embargo, aún subsisten algunas debilidades al interior del sector financiero.

OBJETIVOS DEL PROGRAMA

23. El Programa de Ajuste al Sector Financiero, a ser financiado con recursos de libre destinación del Banco Mundial, tiene como objetivo acompañar el Gobierno de Colombia en el

proceso de ajuste del sector financiero para garantizar la salud y sostenibilidad del mismo y en la introducción de herramientas que propendan por ajustar la legislación financiera colombiana a las exigencias del mercado y a los estándares internacionales. Además, con el fin de garantizar la estabilidad del mercado financiero, es necesario alcanzar un balance entre el sector bancario intermediado y el mercado de valores, que proporcione un eficiente manejo de los riesgos financieros y de liquidez, que blinde al sistema de situaciones adversas de la economía.

24. Para cumplir con este objetivo, el Gobierno ha identificado un conjunto de medidas estructurales que permitirán: apoyar el fortalecimiento de la regulación, la supervisión y los esquemas de resolución de entidades así como el desarrollo del mercado de valores y deuda pública, crear nuevos mecanismos para fortalecer la financiación de vivienda, entre otros. Confiamos en que este conjunto de reformas permita modernizar y flexibilizar la normatividad actual e introducir nuevos instrumentos para proteger la confianza del público en las entidades financieras.

COMPONENTES DEL PROGRAMA

Implementación de la Ley de Reforma Financiera

25. La nueva Ley de Reforma Financiera aprobada el pasado mes de diciembre por el Congreso (Ley 795 del 14 de enero de 2003), que promovió el Gobierno Nacional, deberá ser reglamentada e implementada. Esta Ley incluye cambios importantes para la modernización y fortalecimiento del sistema financiero así como un conjunto de reformas que flexibilizará la normatividad actual e introducirá nuevos instrumentos para proteger la confianza del público en las entidades financieras.

26. Los principales aspectos que aborda la reforma y que tendrán un impacto positivo para el sistema financiero y para el crecimiento económico del país, son:

a) Autorización, a determinadas entidades financieras, para adelantar nuevas operaciones como el leasing habitacional, operaciones de microcrédito, microcrédito inmobiliario, cobertura de la inflación a los créditos individuales de vivienda, entre otros. Se busca estimular la oferta y demanda de crédito a sectores estratégicos.

b) Establecimiento de nuevas medidas de salvamento y resolución de entidades que permitan superar dificultades con celeridad y preservar así la confianza del público en el sistema. Estas medidas son fruto de las lecciones aprendidas de las pasadas crisis financieras y de la experiencia internacional.

c) Establecimiento de normas de protección a los clientes y usuarios del sistema financiero mediante figuras que limitan o ajustan el comportamiento de los intermediarios financieros. Para el efecto, se establecen normas de conducta que deben cumplir los administradores, revisores fiscales, directores y demás funcionarios de las entidades vigiladas. Normas relativas a conflictos de intereses y revelación de información. Y, se crea la figura del Defensor del Cliente.

d) Ajuste al régimen de algunas entidades financieras públicas con el propósito de definir su función dentro del sistema financiero, procurando que su operación se desarrolle de una forma más eficiente y transparente.

e) Establecimiento de un régimen sancionatorio objetivo y coherente. Incorporación de parámetros que otorgan mayor responsabilidad al supervisor bancario.

f) Introducción de otros ajustes relacionados con el sector financiero que van en la dirección de fijar normas claras y prudentes en el desarrollo de la actividad de intermediación y que permitan una adecuada supervisión.

27. La implementación de todas estas medidas contribuirá a la sostenibilidad del sistema financiero y a la efectiva resolución de los problemas bancarios, brindando una mayor protección al ahorro del público y canalizando de manera más eficiente los recursos hacia actividades productivas.

Resolución bancaria

28. Las enseñanzas que dejó el manejo de la crisis financiera por la que travesó Colombia entre 1998-99 fueron: 1) que la regulación existente no contemplaba la estructura para manejar la separación de una institución en banco bueno y el malo y 2) que la liquidación de instituciones financieras es muy costosa para los depositantes.

29. Por lo anterior, y como se mencionó, un tema importante que se desarrolló dentro de la Reforma el Estatuto Orgánico del Sistema Financiero (Ley 795 de 2003) fue la introducción de mecanismos para resolver problemas de quiebra en los casos de las instituciones muy grandes o facilitar la salida voluntaria de instituciones. Se creó la figura de la exclusión de activos y pasivos como medida previa a la toma de posesión que permite transferir rápidamente los depósitos de la institución en problemas a otras instituciones financieras y los activos a un patrimonio autónomo con la posibilidad de que el diferencial sea cubierto por Fogafín. Adicionalmente, se creó la posibilidad de que las entidades pudieran efectuar el desmonte progresivo cuando así lo deseen bajo la vigilancia de la Superintendencia Bancaria y la autorización para que las entidades fiduciarias puedan recibir los activos de las entidades en liquidación con el fin de que se agilicen los procesos de liquidación.

Banca pública

30. Considerando el alto costo de la crisis de la banca pública, el Gobierno decidió que no era conveniente permanecer como propietario de bancos públicos. En ese contexto, se diseñó una estrategia consistente en privatizar aquellas instituciones viables y desmontar las no viables permaneciendo con un sólo banco público.

31. Dentro de la política general, el Gobierno tomó la decisión de liquidar BCH y Caja Agraria, desmontar a BANESTADO y decidió vender sus acciones en dos bancos comerciales (GRANAHORRAR Y BANCAFE). El Gobierno ha iniciado el proceso de privatización de BANCAFE que se estima concluir en el presente año, si las condiciones del mercado lo permiten. El estudio de alternativas para determinar el proceso a seguir respecto a GRANAHORRAR está presupuestado para el 2004. El Banco Agrario de Colombia, se decidió dejar en manos públicas por las externalidades que tiene en cuanto a otorgamiento de créditos y

provisión de servicios financieros en zonas apartadas del país pero con un blindaje especial en sus estatutos y en la Ley que le permite operar bajo criterios comerciales.

32. Como complemento de la estrategia de saneamiento y capitalización de la banca pública, Fogafín adquirió las acciones de la Central de Inversiones S.A. –CISA, para convertirla en colector. A esta entidad se le transfirieron activos no productivos de los bancos públicos por valor en libros de $3.2 billones. Con el fin de disminuir el costo fiscal de la banca pública, reviste especial importancia que la recuperación y realización de los activos recibidos por CISA se produzca en el menor tiempo posible. Dado el carácter de entidad pública, su régimen de contratación y presupuesto no permitían realizar los procesos con la agilidad que se requiere. Por lo anterior, el Gobierno promovió la reforma de su régimen legal la cual quedó plasmada en la Ley 795 de 2003, asimilando su régimen al de Fogafín que permite la contratación y manejo del presupuesto de acuerdo con el derecho privado.

33. Respecto a la banca de segundo piso, en la actualidad existen cuatro bancos de segundo piso en Colombia, cada uno de los cuales se especializa en canalizar recursos a sectores específicos: IFI canaliza crédito a las pequeñas y medianas empresas, BANCOLDEX al exportador, FINAGRO al sector agropecuario y FINDETER a los municipios y departamentos. Dentro de este esquema se puede incluir a FEN y FONADE; la primera se encarga de atender el sector energético y la segunda de adelantar estudios de prefactibilidad y factibilidad de proyectos . Este esquema es muy costoso para el gobierno e impide alcanzar los beneficios de las economías de escala y el uso óptimo de los recursos invertidos.

34. Por lo anterior, el gobierno está diseñando una estrategia para consolidar los bancos de segundo piso. Un primer paso de este proceso que ya fue autorizado por el Consejo de Ministros, es la transferencia de todas las actividades de segundo piso del IFI a BANCOLDEX y la liquidación del IFI. Este proceso se espera culminar en julio del presente año. Una segunda etapa podría consistir en la integración de los dos restantes bancos de segundo piso con BANCOLDEX. Sin embargo, la decisión respecto a la conveniencia y cronograma de esta segunda fase se podría producir al final de 2003.

Reforma del Seguro de Depósitos.

35. Debido a la crisis financiera del período 1998-1999 las reservas líquidas del seguro de depósito fueron consumidas prácticamente en su totalidad y fue necesario endeudarse en un valor aproximado a $2 billones de pesos. Por esta razón, el Gobierno adoptó la decisión de fortalecer las reservas hasta llegar al 5% del total de depósitos en el período comprendido entre 2001 y 2006. Por tal motivo decidió emprender una reforma mediante la cual se aumentó la prima de seguro de depósito que pagan las instituciones financieras a FOGAFIN de 0.3% a 0.6% en el año 2001 y a 0.5% en el período 2002-2006. Adicionalmente, en concordancia con las recomendaciones de Basilea y la Asociación Internacional de Aseguradores de Depósitos decidió implementar un esquema de prima diferencial con base en devoluciones y cobro de prima adicional expost basado en el sistema CAMEL desarrollado por la Superintendencia Bancaria.

36. De acuerdo con la modificación efectuada, el monto asegurado se elevó de $10 a $20 millones de pesos por depositante y por institución sobre el cual existe un deducible del 25%. En razón de que este deducible afecta a los pequeños depositantes que son a quienes el seguro de depósito pretende cubrir, en la Reforma Financiera recientemente aprobada se tomó la decisión de otorgarle a la Junta Directiva de Fogafín la posibilidad de eliminar el señalado deducible.

37. Fogafín está trabajando, adicionalmente, en la modernización del costo de la garantía para los fondos de pensiones y cesantías y compañías de seguros con el fin de que sea diferencial, reflejando el nivel de riesgo de los portafolios administrados por estas entidades y los riesgos actuariales en que las compañías aseguradoras incurren.

Fortalecimiento de la supervisión bancaria

38. La supervisión del sistema financiero se ha venido fortaleciendo con una estrategia basada en la estructura de tres pilares que ha esquematizado el Comité de Basilea: autocontrol por parte de las entidades vigiladas, la supervisión y la disciplina de mercado.

39. En lo relacionado con el autocontrol, se ha puesto énfasis en la implantación de sistemas de administración de riesgos. Dentro de esta política, las instituciones financieras deben desarrollar sistemas adecuados para identificar, medir, controlar y monitorear los riesgos de mercado y crédito. Las compañías de seguros también deben avanzar en la misma dirección. De este modo, el supervisor está promoviendo un cambio desde una postura paternalista a una autosuficiencia donde las entidades vigiladas deben crear sistemas a su medida para administrar sus riesgos. Esta tendencia y cambio cultural debe llevarlos a un conocimiento detallado de sus operaciones y a un mayor compromiso con el control de riesgos. En la agenda próxima se encuentran temas relacionados con los sistemas de gobierno corporativo y de administración del riesgo de liquidez.

40. En materia de supervisión, el trabajo se ha concentrado en diferentes direcciones con el objetivo de mejorar la capacidad de cumplir con la misión de la Superintendencia: velar por la estabilidad del sistema financiero y la protección del ahorro del público. Dentro de este objetivo, se hicieron cambios al interior de la Superintendencia para permitir la supervisión consolidada de los grupos financieros. Especial atención merece el desarrollo normativo que le permite a la Superintendencia requerir programas de recuperación con base en sistemas de alerta temprana. Esta herramienta se usó exitosamente en el caso de los bancos hipotecarios, produciendo como resultado un significativo fortalecimiento patrimonial de las entidades. También debe destacarse el importante avance en la actualización y ajuste de la normativa regulatoria con la aprobación de la reforma al Estatuto Financiero a finales de 2002. Por último, la Superintendencia se ha restructurado para mejorar la coordinación de las unidades de inspección y fortalecer las áreas de regulación y planeación.

41. Para promover la disciplina de mercado, la Superintendencia ha adelantado un trabajo permanente para lograr altos niveles de transparencia e información hacia el publico. La Superintendencia permanentemente está aumentando la información disponible en su página web. Los datos relativos a quejas y sanciones son publicados, además de la detallada información de las cifras y resultados de las entidades mensualmente y en algunos casos con mayor frecuencia.

42. Para concluir, debe destacarse el esfuerzo permanente del Gobierno por lograr estándares elevados en los temas del sistema financiero. Por otro lado, en la *segunda fase del programa* se establecerá un Plan Estratégico para fortalecer la Superintendencia Bancaria y se adelantará un

análisis y evaluación de la vulnerabilidad del sistema financiero a factores endógenos y exógenos.

Financiación de vivienda.

43. Con el fin de consolidar la recuperación del sector de vivienda, el Gobierno ha otorgado prioridad al desarrollo de esquemas para la financiación de la construcción y la vivienda, tales como:

a) Para estimular la demanda de créditos para la clase media, el Gobierno está ofreciendo cubrir el riesgo de inflación incorporado en los créditos de largo plazo a través de un "swap". El Gobierno paga la inflación observada y el deudor una tasa fija, establecida en el 6% por toda la vida del crédito. El cubrimiento del riesgo en que incurre el Gobierno se efectuará a través de la inversión de las reservas disponibles en títulos denominados en UVR o a través de la contratación de coberturas en el mercado nacional o internacional.

b) Otro mecanismo que se introdujo en la Reforma Financiera es el leasing habitacional que permitirá nuevos actores en el mercado de vivienda y que podrá beneficiar a los bancos al reducir el riesgo de crédito asociado y movilizar los activos recibidos en dación en pago además de reducir los costos de los procesos asociados a la recepción de bienes.

c) Por otra parte, el Gobierno continuará apoyando los esfuerzos para titularizar los créditos hipotecarios como una forma de reducir el riesgo de balance. Por lo anterior, es factible que el Gobierno continúe ofreciendo la garantía para los títulos provenientes de procesos de titularización y los bonos respaldados con cartera hipotecaria VIS. En la actualidad se están revisando los cálculos con el fin de establecer las primas que se deberían establecer para las nuevas emisiones de bonos.

d) En la *segunda fase del programa* se piensa evaluar medidas para aumentar la competitividad del mercado hipotecario y armonizar la regulación aplicada a las compañías titularizadoras y las instituciones de crédito.

Desarrollo del sector asegurador

44. La Ley de Reforma Financiera (Ley 795 de 2003) introdujo normas relativas al sector asegurador con el propósito de fijar normas claras y prudentes que permitan la supervisión y la protección de los asegurados e inversionistas de estas entidades y armonizar la legislación colombiana con los parámetros internacionales.

45. Para éstos efectos:

a) Se facultó al Gobierno para que determine el patrimonio adecuado, eliminándose el concepto de patrimonio saneado.

b) Se facultó al Gobierno para que señale el patrimonio requerido para operar los diferentes ramos de seguros que les sean autorizados a las entidades aseguradoras, el cual hace parte del cálculo del capital mínimo.

c) Se autorizó al Gobierno para que determinar el régimen de inversiones.

d) Se modificó los capitales mínimos de reaseguradoras.

e) Se facultó al Gobierno Nacional para que señale las reservas técnicas que se requieran de acuerdo con la naturaleza y realidad de la actividad aseguradora y las características de cada ramo de seguro.

46. Todas estas reformas permitirán contar con un sector más sólido y competitivo. Además, al incorporar ajustes regulatorios que propenden por armonizar la regulación y supervisión de la actividad de las entidades vigiladas por la Superintendencia Bancaria, incluidas las del sector asegurador, se logrará una aplicación integral de normas en beneficio de las entidades y los usuarios de las mismas. En esta dirección, en *la segunda fase del programa* se prevé la implementación de normas de solvencia para el sector asegurador en los diferentes ramos de éste sector.

Desarrollo del mercado de capitales

47. Para alcanzar un eficiente mercado de capitales es importante corregir y equilibrar el desarrollo desigual del mercado financiero intermediado y el mercado de valores; por tal motivo es necesario lograr balancear estos dos segmentos del mercado financiero, los cuales se encuentran estrechamente relacionados por las instituciones que participan en los mismos, por los servicios y productos que ofrecen y por la transferencia de riesgos que ellos permiten. De esta manera, consolidando un mercado de valores transparente, que maneje eficientemente los riesgos financieros y la liquidez y oferta de productos se aumentará la competitividad y productividad del país.

48. El objetivo del Gobierno en la promoción del desarrollo del mercado de valores es asegurar una adecuada protección de los inversionistas y el logro de la organización e integridad del mercado, con el fin de obtener ganancias en la confianza del público, atraer a los inversionistas y mejorar la formación de capital. Esto implica la remoción de barreras estructurales, como el frágil marco legal para el mercado, la debilidad en la capacidad de la Superintendencia de Valores –SV- de realizar la vigilancia y seguimiento de las actividades del mercado, así como de investigar y sancionar conductas ilegales, y el establecimiento y mejoramiento de estándares para los participantes. Muchas de estas reformas se adelantarán bajo el segundo préstamo de la operación programática.

49. Con el fin de proveer un adecuado marco legal para el mercado, el Gobierno presentará al Congreso unas reformas legales diseñadas siguiendo los principios de IOSCO relativas a la protección a los inversionistas, logro de un mercado organizado, justo y transparente, y control del riesgo sistémico. La propuesta consiste en: (i) establecer un marco legal único y comprehensivo para el mercado de valores; (ii) diseñar una arquitectura del mercado definiendo un marco para regular las actividades relevantes, cambiando el actual énfasis de la regulación orientada a los agentes; (iii) fortalecer a las autoridades estableciendo en forma precisa las competencias del regulador y del supervisor, y (iv) corregir los arbitrajes regulatorios.

50. A fin de propiciar el desarrollo del mercado se desarrollarán estrategias relacionadas con la demanda y con la oferta de valores. En el primer caso, se requiere acercar a los inversionistas institucionales a la adquisición de papeles de renta fija y de acciones, por lo que será necesario efectuar cambios en la regulación, así como establecer las barreras de dichos inversionistas para acceder a inversiones de riesgo. Desde el punto de vista de la oferta, se trabajará en la

implantación de principios internacionales de contabilidad, auditoria y contaduría por los participantes en el mercado, al tiempo que se promoverá una transformación de las empresas desde el esquema de propiedad familiar a uno que utilice el mercado de valores,

51. *Enfoque en la Segunda Fase de la Reforma.* La reforma al marco regulatorio también incluye aspectos como: (i) los estándares de buen gobierno corporativo de los emisores (papel de las juntas directivas, administradores, auditores y otros); (ii) los estándares de profesionalismo y gobierno de los intermediarios; (iii) la emisión de normas y los procedimientos de publicidad; (iv) el ambiente regulatorio para las emisiones en el mercado público y las ofertas privadas; (v) el fortalecimiento de la autorregulación, extendiéndola a todos los agentes; (vi) las licencias para todas las actividades relevantes, que actualmente no están bajo supervisión; (vii) el mejoramiento de los estándares de los sistemas de compensación y liquidación de valores (marco legal para la creación de una cámara de compensación riesgo central de contraparte, desmaterialización y anotación en cuenta en registros electrónicos para los nuevos valores – con algunas excepciones-, la regla de hora cero y otros); (viii) la unificación de las normas para los fondos de inversión colectiva; (ix) la definición clara de infracciones y de sanciones y de criterios para su aplicación, y otras.

52. El programa para el desarrollo del mercado de capitales también contiene el fortalecimiento de la capacidad de la SV de realizar la vigilancia del mercado y adelantar procedimientos de investigación y sanción. Además de la inclusión en el proyecto de ley del mercado de un catálogo preciso de infracciones y sanciones, y procedimientos especiales para realizar las investigaciones administrativas, el Gobierno realizará la modernización y reingeniería de la SV, para incorporar (i) la reorganización de la entidad (por decreto) creando un área especializada de fondos colectivos, una de intermediarios y mercados para regular la entrada / salida y realizar la vigilancia preventiva de los agentes, y una de supervisión enfocada en la investigación y sanción de conductas contra el mercado; (ii) la automatización del sistema de monitoreo del mercado (incluyendo la vigilancia sobre la actividad de supervisión de la bolsa); (iii) la definición de autorregulación, que incluye a todos los participantes en el mercado (bolsa de valores, sistemas electrónicos de negociación, sistemas de compensación y liquidación de valores, y otros); (iv) la coordinación con la Superintendencia Bancaria –SB- respecto de actividades de supervisión común, incluyendo la supervisión de grupos financieros y fondos de inversión colectiva, buscando eliminar el arbitraje regulatorio actual entre los fondos fiduciarios vigilados por la SB y los fondos de valores que están en la órbita del control de la SV; (v) el establecimiento de manuales operacionales, y (vi) el mejoramiento de las competencias técnicas de los funcionarios.

53. Para fortalecer los instrumentos de regulación prudencial para supervisar al mercado de valores, la SV ajustará los requerimientos de capital de las entidades bajo vigilancia, incluyendo a las sociedades comisionistas de bolsa y a la sociedad titularizadora (armonizados con la regulación de la SB), con el fin de requerir que dichas entidades asignen capital de acuerdo con los riesgos que corren en sus operaciones. Además, siguiendo estándares internacionales, la SV establecerá parámetros para vigilar a estas entidades, orientados en requerimientos de control interno y estándares elevados de gestión y control de riesgo, con el fin de mejorar la disciplina del mercado.

54. La SV continuará con la implementación de la regulación de valoración a precios de mercado, acordada con la SB. Estas entidades y el Banco Central, establecerán un comité asesor de valoración, con la participación del sector privado, con el fin de obtener estándares de buen

gobierno en la unificación de las metodologías de valoración para títulos de deuda pública, deuda pública externa, otros títulos públicos y valores de deuda privada.

55. La SV mejorará la regulación de los valores hipotecarios, en aspectos tales como (i) la implementación de un apropiado esquema de vigilancia de las sociedades titularizadoras; (ii) la adaptación de normas para valores hipotecarios para hacerlos viables para la movilización de hipotecas de bajo desempeño; y (iii) el mejoramiento de las metodologías de valoración para categorías específicas para estos tipos de papeles.

56. La SV hará una revisión del marco normativo y de funcionalidad de los sistemas de negociación para mejorar la transparencia y justicia en la formación de precios en los sistemas de negociación.

57. Finalmente, el Gobierno emitirá una guía con los términos y condiciones para la introducción del mercado de derivados en Colombia (futuros y opciones, financieros y sobre productos).

Desarrollo del mercado de deuda

58. La Dirección de Crédito Público del Ministerio de Hacienda piensa estabilizar, a mediano plazo, la deuda total de la Nación. Esto es, pasar del actual nivel de 53% del PIB a 47% del PIB. La estrategia conjunta de deuda interna y externa (incluyendo en esta última los préstamos multilaterales) busca darle prioridad a la financiación en deuda interna sobre la externa; para el 2010 se espera una proporción aproximada de 60:40 en el stock total de deuda.

59. En términos de deuda interna la estrategia es bajar la duración ligeramente a 2.1 años (de 2.4 años actuales). Sin embargo, la duración total de la deuda pública no se debe afectar pues para ello se aumentará la duración de la deuda externa, a través de la emisión de bonos por un valor de USD 1000 millones, de los cuales USD 500 millones fueron ya a 10 años y USD 500 millones a 30 años; igualmente, los préstamos multilaterales también ayudan a extender la duración de la deuda externa.

60. En el tema de deuda externa quedaría un tema adicional que es el manejo del perfil de vencimientos. Para ello, en este año se busca actuar en dos frentes: uno, los altos vencimientos de los años 2005 y 2008 y dos, arbitrar la diferencia entre la curva para los bonos en dólares y en euros, pues los últimos están 150 p.b. por encima del mercado americano.

61. La estrategia de deuda interna es primero modificar el esquema de creadores de mercado a través de la ya emitida Resolución 001 del 2003, la cual aumenta la exigencia de la participación y reduce, hacia delante, el número de participantes. Segundo, se busca el desarrollo de la parte corta de la curva, a lo largo del año, de la siguiente forma: i.)Para los bonos TES de 90 y 180 días, de forma tal que halla formación de precios eficientes que hoy en día no existen; ii.) Para los bonos de 1 año incrementando su liquidez de forma tal que sean el benchmark de 180 días a mediados del año iii.) Para los bonos de 2 a 5 años aumentando la liquidez dándole a los agentes alternativas de inversión a papeles diferentes de 10 años, tales como las fiduciarias y los fondos comunes de valores.

62. La estrategia de focalizarse en la parte corta de la curva implicará disminuir la duración de la deuda. Con ello, también se reduce la transferencia del riesgo de duración ya que no hay

desarrollo de esquemas para cubrir este tipo de riesgo. Los plazos de cinco años serán colocaciones más esporádicas que los de los otros plazos, y buscan darle espacio a los Inversionistas finales como fondo de pensiones y compañías de seguros, por ejemplo.

63. Por otro lado, los papeles en UVR están concentrados en plazos de más de cinco años. La emisión de los UVR no son emisiones rutinarias sino esporádicas, y se realizan solo cuando se puede concentrar un mayor volumen.

64. Finalmente, la estrategia de deuda interna se basará en los bonos "plain vanilla" y los indexados a UVR, dándole a éstos unos volúmenes de liquidez adecuados. Así, se buscará reducir el monto actual de bonos poco líquidos como los indexados a la TRM.

65. Paralelamente, se complementará el esquema de deuda pública con el desarrollo de instrumentos paralelos como los repos, las simultáneas, el esquema de transferencia temporal de valores y, finalmente, los futuros. Todo ello para el año en curso del 2003.

III. CONCLUSIONES

66. La aplicación de las medidas y políticas previstas por el Gobierno, parte de las cuales se recogen en el Programa de Ajuste al Sector Financiero, a ser financiado con recursos del Banco Mundial, permitirán que el país pueda contar con un sector financiero sano, necesario para apoyar la recuperación y crecimiento de la economía, y que propenda por modernizar y flexibilizar la normatividad actual e introducir nuevos instrumentos para proteger la confianza del público en las entidades financieras así como ajustar la legislación financiera colombiana a las exigencias del mercado y a los estándares internacionales.

67. Por último, el Gobierno está comprometido con el programa que se presenta en este documento y ve con beneplácito el acompañamiento y el apoyo financiero del Banco Mundial a estos procesos. El Gobierno agradece la pronta consideración por parte del Directorio del Banco del primer crédito programático de ajuste al Sector Financiero contemplado en el CAS para Colombia para el período 2003-2006. El Gobierno está a disposición de los equipos técnicos del Banco para definir conjuntamente programas futuros de crédito en la medida en que se consoliden los ajustes y se requieran nuevas acciones en el sector financiero.

BANKING REGULATION AND SUPERVISION IN COLOMBIA

Recent Regulatory Developments

191. Since the crisis period, a host of circulars in 2001-02 were developed to make more consistent the implementation of the legal provisions that govern problem debt restructuring (PDR), as legislated by several Laws in 1999 (546, 550 and 617). There are still, though, some gaps between this framework governing PDR and existing international doctrine (FAS 15 and others), but the rules provide for a relative complete and integrated framework of disclosure, valuation and reporting for loans that have been restructured as per the definition under the circulars.

Analysis and Recommendations

192. Areas where actual PDR practices would benefit from further review and, eventually, where regulations could subsequently be improved, would include: the scope itself of PDR transactions, beyond that of problem loan PDRs; the clarification of "sustained performance" ('pago regular y efectivo'); the reversal of provisions following restructuring; associated interest capitalization rules; the extension of such rules to spun-off and offshore units; and, actual debt relief tests for PDR long term viability.

193. *Market Risk Regulations*: The most important recent regulatory achievements relate to those risks that were not previously supervised. Circular CE 042/2001 includes market risks in the capital adequacy formula, permitting banks to use internal VAR models or, alternatively, to follow a standard approach developed by the Superintendency, an option to which most banks have conformed. In addition, Circular CE 033/2002 – which modifies the overall code of rules set by CU 100/95 - has regulated in greater detail the valuation of securities portfolios, including the distinction and transfers among trading transactions, those available for sale, and those held to maturity.

194. Circular CE 033/2002 has facilitated the implementation of capital charges for market risks and made more transparent, homogeneous and consistent, the securities valuation rules. Together with CE 042/2001, it has established, as well, a framework of qualitative market risk standards to which bank management is expected to progressively adhere to. Though this Circular could be improved marginally in several aspects, it is presently more of an issue of consistent implementation, and of systematic and homogeneous supervisory enforcement. This also includes training examiners to carry on evaluations of bank practices in capital market and trading activities, extending to new off-balance sheet products being traded, and related hedging strategies.

195. *Credit Risk Regulations*: The most important regulatory development, albeit, was the introduction in early 2002 by Circular CE 011/2002, of a new credit risk management system ("Sistema de Administración de Riesgos de Crédito, or SARC". SARC extends beyond the traditional deterministic approach to loan classification and provisioning, and is probably (besides the Mexican case) among the most advanced and complete regulations of its kind in the Region. SARC requires bank directors and senior management to set in place an integrated

credit risk management process, including: a) an adequate organization for credit activities; b) a credit business strategy as well as identified business segments; c) detailed credit policies and procedures; d) a methodology to measure credit risk; and e) independent controls to ensure adherence to both the bank's internal self imposed, as well as regulatory requirements.

196. These qualitative standards are further complemented with an advanced approach to loan classification and provisioning. Bankers are given two distinct alternatives for that purpose: i) using the traditional regulatory deterministic approach – composed of the customary five risk grades with pre-established provisioning levels; or ii) using internal methodologies based on appropriate procedures and data to rate credits, by risk grades in homogeneous segments. Bankers are expected to associate a probability of default and an estimated loss (given default) to each risk grade.

197. Banks have, therefore, the possibility of provisioning loans based on the expected loss estimated using the two previous basic parameters, provided that the Superintendency has approved the complete credit risk management framework. CE 010/2001 though, establishes as a floor for provisioning purposes the deterministic regulatory levels, a rule which would need to be reviewed in light of the actual progress achieved by bankers in developing their methodologies.

Diagnosis and Issues Encountered in Regulation and Supervision

198. With few minor exceptions, already in the course of being addressed, the Colombian regulatory framework for banking would appear very advanced, and close to achieving a substantial degree of convergence with best international standards of regulatory practice. Accordingly, the fundamental issues going forward would relate more to the effectiveness, efficiency, and capacity of Supervision, rather than to the adequacy of the regulatory framework. This is precisely the focus of the Superintendency for moving forward: to center its development efforts into strengthening its supervisory processes and procedures, providing effective incentives to bankers to operate prudently; to improve its consistency in evaluating the latter; to communicate better with the industry and be able to elicit remedies, and limit resorting to ex post sanctioning; and to improve the dept and capacity of its supervisory staff, providing them adequate training and compensation.

199. Under the future Basle Pillar Two, supervisors are expected – as several developed countries already do - to require additional add-ons to the minimum ratio, including the use of trigger capital ratios, for those institutions whose risk management frameworks exhibit circumstances that warrant imposing higher operational capital requirements.

200. *Development of the Supervisory Framework*: The approach to supervision by the SB has also been evolving in tandem with regulations and the priorities imposed by events in (and the condition of) the financial system. In 1998, it decisively moved away from focusing in off-site surveillance to the much more intensive emphasis placed today in examining solvency. The agency recognizes, however, the need to further its approach, incorporating risk-focus elements into its culture, and adjusting, accordingly, its planning processes, policies and procedures.

201. For the Superintendency, its actual effectiveness depends crucially on the rigor and depth of onsite examinations, including the quality and transparency of financial and risk exposure information reported by banks. Thus, besides effectively incorporating risk parameters to supervision, the Superintendency is planning additional efforts to solidify and make more

consistent practices among teams of examiners, specially regarding asset and earnings reviews – and the assessment of group related activities --, as preconditions for evaluating the sufficiency of capital and, hence, financial solvency.

Consistency and Dissemination of Procedures

202. It is clear to the Superintendency that the recent fast change experienced in regulations has outpaced the framework (strategic plan and priorities, processes and policies, procedures and personal capacities) under with which it has been operating. Its purpose is to make that framework more consistent among its different sub-sectoral Intendencies (called "Delegations" or Delegaturas), ensuring that quality assurance in terms of adherence, consistency, uniformity, effectiveness, and efficiency, is formally instituted within the Directorate of Supervision.

203. With the formalization of its operating policies around risk assessments of banks, the Superintendency will seek venues to institutionalize its evolving culture across Administrations and Superintendents. In this manner, the Superintendency is aiming at elevating the stability of its "prudential concerns", making them durable, and gaining in this manner, further independence and autonomy. Moreover, the Superintendency is aware of the need to foster its image as provider of a level playing field to industry participants, while retaining the necessary flexibility to carry on its duties. To that end, the Superintendency intends to communicate publicly how it intends to supervise, in order to appear transparent about the criteria governing its main decisions and interpretations, so that supervision becomes more predictable and consistent across the system, further gaining in stature vis-à-vis the bankers.

Key Future Reforms to be Undertaken by the Superintendency

204. Besides making more precise the scope of oversight of consolidated financial institutions, by means of more consistent and uniform definitions of related parties and financial groups, the reform effort will ensure that adequate combined risk limits are established for overall groups of insiders of financial institutions, including -- but not limited to -- those companies where significant shareholders of a bank, maintain or exert control – individually or as a whole -- as well as appropriate capital deductions for any limit excesses.

205. *Remedial Actions and Enforcement of Sanctions:* The Superintendency will make public – as necessary by means of a combined set of regulations, policy stances, and process descriptions on its web site -- a revised regime for remedial actions and enforcement sanctions, consistent with the purpose mentioned before. It will further develop the provisions of Articles 208 to 212 of Law 795/2003, establishing a more efficient, transparent and objective graduated regime of remedial actions and enforcement sanctions. Such regime will extend beyond formal regulatory compliance and consider the relative and prospective levels of financial condition, adherence to internal governance and risk management standards, and progress in implementing reorganization plans approved or previously requested by the Superintendency.

206. The regime will add incentives for bankers to abide by prudent standards of business and financial practice, as well as to comply with law and regulations, including objective rules to determine what levels of capital, in addition to the minimum established, the Superintendency will require for those individual institutions with adverse risk profiles, including: lesser granularity of regulated risks; greater accumulations of unregulated risks such as interest rate risk in the banking book, liquidity and operational risks; and lower than warranted adherence to risk management and internal control standards.

207. Rather than resorting solely to imposing pecuniary sanctions, the new regime will focus in eliciting positive and effective responses from bank owners, and from directors and senior management, for adopting effective remedies in addressing concerns of the Superintendency. A such, the regime will explore additional venues to provide incentives to bankers to bank prudently, including operational limitations to mitigate risk, and other alternatives. The Superintendency intends to explore for such purposes, whether to use individual regulatory capital triggers and operational ratios in excess of the generally minimum capital adequacy established. This would thus advance the introduction of new supervisory standards put forward by pillar two of the new BIS Accord being developed. Moreover, the regime will determine proportional sets of economic sanctions, applied both to banks and accountable individuals when remedies and orders approved by the Superintendency are not complied with, including explicit identification of the degree of gravity of offenses committed.

208. *Internal Corporate Governance Standards*: The Superintendency will implement, as well, the codes of conduct and duties required by Articles 12 to 15 of Law 795/2003, including a more detailed set of standards for board processes, their functioning and their operating committees. Among other aspects, the standards will expand, to ensure that directors and senior management create an adequate control environment, and operate effective internal control systems --both organizational and procedural-- as well as robust and independent internal audit and risk management functions for assessing adherence to such controls, internal policies and procedures, and to goals set for the institution. These standards will add and complement those discussed earlier that have been already issued for market and credit risk management. They will be followed, as part of the second operation, with further themes, such as liquidity risk management, creating in this manner a robust framework of qualitative and enforceable bank business and financial standards.

209. *Conflicts of Interest*: The Superintendency will establish, as well, regulations to implement Articles and 35 to 36 of the Financial System Reform Law. These will consist of measures to mitigate conflicts of interest under major decisions and transactions where significant shareholders of an institution, directors or senior management, are parties. These regulations will include also measures and supporting information systems to improve the identification of such transactions including those entered with parties related to the above persons where they exert control or significant influence; to track the performance of all related operations both at an aggregated and individual level; and to facilitate conducting comprehensive supervision of financial conglomerates and related non-financial sector concerns.

210. *Credit Risk Parameters:* Based on the recommendations of the expert evaluation carried out regarding experiences in supervising the implementation of Circulars on integrated credit risk management processes by banks, the Superintendency will determine which additional refinements are necessary to ensure a satisfactory, risk contained migration by qualifying banks to the new credit loss provisioning regime. These refinements will include additional capital-compatible regulatory incentives that could be appropriate and feasible to introduce, in order to facilitate a level playing field for the most advanced risk management practitioners in the system.

EVALUATION OF THE INSURANCE REGULATORY FRAMEWORK WITH RESPECT TO IAIS CORE PRINCIPLES

BACKGROUND AND DEVELOPMENTS IN THE COLOMBIAN INSURANCE SECTOR

Adequacy According to IAIS Core Principles

211. The adequacy of the insurance sector legal, regulatory and supervisory framework was conducted by an independent consultant to determine the degree of adherence of Colombia's insurance regulation to the Core Principles established by the International Association of Insurance Supervisors (IAIS).

Organization of the Insurance Supervisor (C.P. #1)

212. The Insurance Supervisor's Office ("Delegatura de Seguros") at the SB is in charge of the supervision of the insurance sector. This Department has a staff of around 70 professionals and assistants. The staff is mainly organized around three teams and each of them is in charge of the control of a set of companies through on and off site financial examinations. For this purpose, the insurance entities are classified into different categories: Foreign companies (these are supervised by one team that increasingly relies on an "early warning system" and risk analysis), conglomerates, domestic independent companies and "capitalizadoras". The group of local entities is split into two sets (each of them supervised by a specific team). Insurance brokers are also supervised by this Delegatura. Finally, two other Divisions of this Delegatura have specific functions different from direct supervision of the licensed entities: One is in charge of legal control, filing of policies and keeping the registers of reinsurers and insurance brokers, and the other looks after internal control, elaboration of statistics and preparation of proposed regulations. Within the SB there is a Committee where the Delegates of the different sub-sectoral Departments participate with the Superintendent. The Committee is in charge of evaluating the "fit and proper" criteria for senior management of insurers as well as taking care of Corporate Governance issues.

213. The SB has two other Departments that provide services to all its areas of supervision and hence to the Delegatura de Seguros: Legal support (Dirección Jurídica and Dirección de Regulación) and technical and actuarial support (Dirección Técnica). In general terms the Delegatura de Seguros at the SB is sufficiently staffed and well organized. It is considered to have efficiently developed its role of controlling the Insurance Sector. However the challenges derived from the new shift towards a "risk based" supervision require new resources and training programs for existing staff. Finally, in this new environment, the technical and actuarial control will become more sophisticated and specialized, very possibly requiring that the Delegatura form its own team of actuaries instead of relying entirely on more generalist actuaries from the SB's Technical Division.

Licensing and Changes in Control (C.P.'s # 2-3)

214. All Insurance entities must be incorporated in Colombia (even if 100% of the share capital is foreign owned) and they must seek a specific authorization for each line of business ('ramo') in which they wish to operate. The Law establishes that there must be separate legal entities for

life and non life products. However non life companies can sell certain group life contracts. The legislation leaves a grey area when defining which activities are subject to insurance regulation in the fields of pre paid health care (with some type of HMOs not being considered insurance entities) and pre paid burial services (also explicitly excluded by Law 795/2003).

215. All insurance brokers are also required to register at the SB. The changes in control of the shares of registered entities must be duly communicated to the SB. The SBC has the authority to object to new shareholders if it finds that such a change might endanger the solvency of the company or challenge "fit and proper" principles.

Corporate Governance (C.P. # 4)

216. The insurance regulation makes no reference to corporate governance principles. The corporate law and the recent law regulating the Financial System (Law 795/2003) addresses issues such as the role and responsibilities of the board of director, conflicts of interest, checks and balances, and some rights of minority shareholders. However, it does not explicitly empower the SB to request companies to adopt specific corporate governance principles. Nevertheless, the law requires insurers to establish procedures for dealing with complaints from customers; to monitor all risks involved in the development of their activity, and to have external auditors.

217. The law does not establish sufficient powers for the SB, in the area of corporate governance. The SB thus has resorted to administrative procedures (the most recent is the Circular Externa 052 of December 20th 2002 that modifies the Circular Externa 007 of 1996) which only indirectly address corporate governance issues, namely through the request to produce written policies that define the administration of financial, operational and reputational risks. The 795/2003 law also requires that financial institutions set adequate procedures to deal with customer complaints. The insurance regulation is in the process of being amended to allow the SB to require boards of directors to adopt specific corporate governance mechanisms.

Internal Controls (C.P. #5)

218. The insurance regulation does not enable the SB to require the establishment of internal controls to address such issues as: organizational structure, separation of critical functions, cross checking of activities, and decision making procedures. There is also no special provision in the law regarding the requirement for companies to establish an ongoing internal audit function. This relates to the lack of positive regulation on corporate governance.

219. Notwithstanding the absence of a specific regulation on internal controls, the insurance regulation enables the SB to supervise and review internal controls approved by the board of directors. Supervision of internal controls is achieved by the external auditors and also by the SB during on-site inspections as the law states that the SB has the authority to review information on organization, operations, accounting practices, investments, and other information deemed necessary.

220. Regulation enables the SB to require directors to establish standards for underwriting and investment risks. Underwriting standards are to be clearly established for each product. It is required that new products be filed at the SB to allow their review. Companies are only required to file documentation (sample contracts and technical notes) relative to new products, or any modification to existing ones. However in practice most insurers will wait until they receive an

explicit response from the SB before launching any new products or introduce changes. The SB ensures that products are legal and fair.

221. The regulation enables the SB to require directors to establish standards and monitoring controls on fair treatment of customers; proper disclosure to customers of policy benefits, and risks and responsibilities. Companies must advertise their products in a clear and precise way in order not to engender confusion about the services that the company offers. The SB has the power to order companies to modify or suspend marketing activities if these principles are not followed.

222. Finally, the regulation requires the establishment of a formal system for the analysis of insurance risks (SEARS) that must be approved by the SB. Depending on the criteria that the SB uses for those approvals, it could play an important role towards the reinforcement of the internal control procedures that insurers should have in place.

Prudential Rules (C.P.'s # 6-10)

223. The law establishes standards with respect to the assets and liabilities of companies licensed to operate in the jurisdiction. Assets should be invested with the aim of maintaining adequate levels of safety and liquidity. The decrees that regulate reserving requirements are 839/1991, 2345/1995, 2347/1995 2655/1997, 2656/1998 and 94/2000. The Decree 94/2000 is further developed by Decree 2779/2001.

224. In order to guarantee a safe level of diversification, maximum limits are established on generic investments by type of assets. Further detailed limits are set for some investments. Investment in real estate and in loans is not permitted. Until relatively recently there were no adequate rules in place for the investment of technical reserves. This was finally changed in 2000. However, the practices of many insurers had been so loose until then that the change of criteria resulted too difficult to be implemented at once. For that reason, the rules on the investment of reserves (94/2000) established a gradual implementation of the investment rules. The percentage of the reserves that must comply with the investment rules have been phased as follows:

- By December 31st ,2000:: 45%
- By December 31st ,2001: 50%
- By December 31st ,2002: 55%
- By December 31st ,2003: 60%
- By December 31st ,2004: 70%
- By December 31st ,2005: 80%
- By December 31st ,2006: 90%
- By December 31st ,2007: !00%

225. Concentration of investments is dealt with by limiting the risks for each institution..

Finally, a proper matching in the denomination of assets, is required for contracts with sums insured which are denominated in foreign currencies. Derivatives should only be used as a hedging instrument, not as an investment instrument.

226. As a general rule assets are to be valued at market price. For those more illiquid assets that are not frequently traded, some rules are established to ascertain a fair market value. Some fixed

income assets can be earmarked by the insurer and then would be valued at their acquisition cost plus the corresponding accrual of the financial return. The insurer has to keep these bonds in its investment portfolio until maturity.

227. The Technical Provisions (policy liabilities) required by the Law 795/2003 are:

- Unearned premium reserve (called the reserve for unexpired risks)
- Mathematical reserves (for life policies)
- Outstanding claims reserve
- Claim stabilization reserve (contingency fund)

228. An important rule introduced by Law 795/2003 is that it empowers the SB to define the additional types of reserves that insurers will have to establish according to the needs of each line of business. Under these rules, the actuarial valuations of technical provisions for the life business must be conducted using the same basis used for pricing the corresponding product. For non life operations the provision for pending risks is equal to the unearned premium at the moment of calculation, assuming a uniform distribution of the risk over time. The SB is preparing regulations that will require a better establishment of appropriate technical provisions for claims incurred but not reported, although no mention seems to be made at this stage for claims incurred but not reported fully.

229. Most of the investments for the technical provisions and the minimum capital requirement, consist on government bonds. Bonds from private issuers and shares are well below the maximum limits permitted by the regulatory framework. According to the present rules in force, an insurer could invest 100% of its technical provisions in the private sector, provided it fulfilled the diversification criteria. To a certain extent the existing investment mix is a consequence of the availability, or lack of, of alternatives in the capital market that would otherwise attract the insurer as a prudent investor.

230. Several issues could be taken into consideration to improve the valuation of assets and liabilities. The assets earmarked until maturity are possibly too strictly locked into the portfolio. This might bring difficulties in optimizing the reinvestment policy as it produces a shorter timeframe over which the reinvestment decision has to be made. It would be advisable to analyze if a certain degree of flexibility could be introduced in line with some general accounting principles.

231. In the cases where the method of determination of the technical provisions is based on the same assumptions that were used for fixing the premiums (contractual assumptions), the results would not reflect the changes that might have occurred for the risks covered since the premium was determined. The resulting level of provisions would thus not reflect in those cases, what the true underlying liability was. This effect produces an over valuation of the life liabilities when the rate of interest used in the calculations is below the expected return on investments and the mortality tables show a margin compared to actual experience. However in other scenarios, the liabilities might be undervalued. In non life branches the unearned premium reserve might not be sufficient in the cases where expected risks exceed that portion of the premium.

Market Conduct (C.P. # 11)

232. Companies are required to establish standards of fair treatment of customers, and proper disclosure to customers of the policy benefits. Companies must advertise their products in a

clear and precise way in order not to engender confusion about the services that the company offers. The SB has the power to order companies to modify or suspend marketing, if these principles are not followed. Adherence to market conduct principles contained in the Law, is evaluated during on-site supervisions.

Monitoring, Inspection and Sanctions (C.P.'s # 12-14)

233. On-site inspections have as the objective, the control and evaluation of revenues, liabilities, capital, operations, internal controls, and any element that could affect the financial position of a company. Two types of inspections are foreseen: (a) Ordinary, and (b) Special.

234. The first type of inspection belongs to the annual program of inspections. Special inspections can be the result of off site analysis of financial and operational information that the insurer has filed at the SB, or it can be provoked by an external report of an incident. The regulations establish a detailed framework for disciplinary measures that the SB can adopt depending on each situation (failure to facilitate the requested information, mismanagement, fraud, etc.). Economic sanctions are decided in the case of most of infringements of their duties by insurers, brokers or agents, but in extremes cases the SB is allowed to withdraw the operating license or even request the liquidation of the insurance entity.

Cross-border Business Operations (C.P. #15)

235. There are no relevant cross border operations conducted by insurers licensed in Colombia, except in the cases of Marine Insurance. No relevant issues have been raised regarding this principle.

Supervisory Coordination and Cooperation, and Confidentiality (C.P.'s # 16-17)

236. The SB pays special attention to international collaboration with the Insurance Supervisory Authorities in other countries, especially in the area of uncovering money laundering schemes. However its communications to some Insurance Commissioners or similar authorities are not followed by any relevant feedback that would allow the SB to follow up on cases towards subsequent stages. The SB is rarely informed about the measures taken by the foreign supervisor against foreign companies illegally operating in Colombia. In some cases the actions taken, end up successfully uncovering money laundering schemes. This is the case of a recent action taken jointly by the Colombian, U.K. and U.S. authorities together with the Isle of Man customs department, that allowed the seizure of around US$ 8.75 million. The complex scheme had been designed to launder the proceeds of Colombian drugs traffickers through the international life insurance industry in the USA and through international finance centers.

237. Until very recently, the law in Colombia did not allow the SB to become a member of multinational organizations of Insurance Supervisory Authorities where it had therefore just sit as an observer. The law 795/2003 allows the SB to become full member of ASSAL (Asociaci6n de Superintendentes de Seguros de América Latina) and IAIS (the International Association of Insurance Supervisors)

The SEARS Approach

238. The SB, through External Circular No. 052 of Dec. 2002, established the requirement for adopting formal procedures in the analysis and measurement of all risks that affect the

development of activities of any insurance company. Each insurer is requested to produce its own SEARS method (Sistema Especial de Análisis de Riesgos de Seguros) which must be approved by the SB. A time schedule for the implementation of SEARS has also been issued:

(i) The first Phase must be submitted for approval by the SB before October 2003 and consists of the design and adoption of the general structure of the system, including:

- Written policies concerning risk management;
- Mechanisms and procedures for the identification of risks that affect each of the areas of exposure;
- Design of the human resources and technical means necessary for the management of these risks;
- Design of the procedures for controlling these risks;
- Design of the mechanisms that will be used for the adequate control of these risks;
- Mechanisms that will assure a proper internal communication of the policies and procedures of control;
- Tools that will be used for training and preparing the staff in charge of managing the risks within the company.

239. Once approved by the SB, the insurer will count on a further ten months for the implementation of the structure of SEARS.

240. The second Phase consists of the design, adoption and practical use of the methodologies for the measurement of the risks. Beyond further risks that the insurer might consider, this norm requires the use of at least the following concepts:

- Credit risk in the insurance business (policyholders, reinsurers, brokers, agents, other insurers);
- Insurance market risk;
- Insurance related liquidity risk;
- Underwriting risk;
- Pricing risk;
- Reduction in premiums (commercial discount) risk;
- Concentration risk;
- Risk of asymmetric conditions (coverage, or other conditions of direct insurance different from conditions of reinsurance);
- Risk of under-reserving;
- Legal risk;
- Operational risk;
- Strategic risk; and
- Reputational risk.

241. It has not yet been disclosed how the implementation of SEARS will be used to determine the minimum solvency requirements that will be requested from each insurer, which would pertain to the time when full implementation of a Risk Based Capital environment would be achieved. To a certain extent, this would arise in a third phase when insurers will need to implement the quantitative models for those risks identified as measurable, during the second phase.

Overall Assessment of the Sector

242. In general terms, the SB, and more specifically the "Delegatura de Seguros" within the SB, is properly developing its controlling function over the activities of the entities that shape the insurance sector in Colombia. Very recently, law 795/2003 provided the government with flexible regulatory powers in the insurance industry with respect to the establishment of criteria ruling which technical reserves need to be created by insurers and to determine the minimum required solvency margin. All these changes are taking place as part of the new trend emphasizes the regulatory and supervisory activities for an adequate control by insurers themselves, of the risks underlying all areas within their activity.

243. In the near future the SB should use these new tools and introduce necessary regulations to require insurers to build up those technical reserves in order to better reflect a prudent estimation of their liabilities at each moment in time, and, on the other hand, redefine the minimum solvency margins per line of business (including a revision of the minimum capital requirement). This would not only reinforce the financial strength of insurers but also serve as a stimulus towards the introduction of best practices in terms of underwriting, investment of reserves, reinsurance arrangements, relationship with clients, and consolidation of business growth strategies. However, for the time being it is advisable to pursue improvements under the present methodology which uses the European formula for fixing capital and minimum solvency margins, and a classical reserving approach.

244. A proper implementation of the SEARS scheme requires a significant cultural change on the side of the insurance industry but also on the staff of the SB, both in terms of broadening the knowledge base and management style. At present, the market might not be prepared for such a drastic change. While this phase of analysis might be a good exercise for bringing awareness on the new priorities that need to be introduced and will certainly have beneficial consequences as it will encourage the adoption of formal procedures with a stronger emphasis on risk management, the phase of implementation might come under the present schedule, too soon to have the SB and the industry count on the necessary resources to guarantee a successful result.

245. There is a very relevant international trend to shift the insurance regulation and supervision towards a risk based system that will require changes in many countries similar to what the SEARS attempts to achieve in Colombia. However, the different forums where the discussions are taking place to set the standards and criteria over which those changes will be based (the International Association of Insurers Supervisors, IAIS; The International Actuarial Association, IAA; and The European Union Commission) have not yet reached final conclusions or recommendations. In that regard it would be prudent to count with such references and benchmarks before forcing any full implementation of a new system.

Annex 5

THE GOVERNMENT SECURITIES MARKET AND ITS LINKS TO THE DOMESTIC CAPITAL MARKET

DIAGNOSIS FOR THE MEDIUM TERM FRAMEWORK

246. Three key areas are identified as the main axes to support a comprehensive reform in the market of public debt instruments:

- debt market development with special emphasis in the near term, on the definition of an operational debt issuance strategy;
- strengthening of the money market with special emphasis on the development of local repurchase agreements and treasury bill markets; and
- a package of actions to improve risk measurement and management by various market participants. In this last area, improvements in reporting and related analysis of balance sheet risks of end investors will be a special focus of reform efforts in the near term.

247. *Debt Market Development*: There are two key priorities in the debt market development area. Given the importance of being able to build credibility as the large local debt is rolled over, an explicit operational short-term debt issuance strategy must be expeditiously articulated by the authorities. This will release time so that work can commence on the second priority: a longer-term debt issuance strategy. To be effective, any strategy will have to be developed and approved under strong and clear governance arrangements. The authorities will, as an element of such a governance arrangement, re-constitute and strengthen the debt management committee where high-level issues pertaining to this area can be discussed, and conflicts can be resolved.

248. To reduce vulnerabilities in the private sector from the transfer of market risks, the government has had to limit the debt duration. Although this increases interest rate refinancing risk for the authorities, the ability of the private market to absorb and manage these risks needs to now be explicitly taken into account in the formulation and design of the debt issuance strategy.

249. The authorities currently decide on instruments and amounts to issue very shortly before each auction. Transparency and predictability is sacrificed both by this practice, and by the recently introduced global limit for the auctions. Currently market perception is that the funding strategy is driven by short term shifting views on interest rates. This increases uncertainty in the market and impacts funding costs. The authorities will develop a clearly formulated funding strategy at least for the year 2003, to be discussed by the debt management committee and approved.

250. *Money Market Development*: An essential building block to support risk measurement and management, is development of the money market. Instruments such as T-bills or CDs are the natural instruments to be held in the portfolios of money market mutual funds. The lack of money market development has been due in part, to the debt issuance strategy that has not focused adequately on development of the short term T-Bill market. At another level the presence of two major liquidity providers, the Treasury (DTN) and the Central Bank (BR), with different conventions in such key areas as haircuts for market risk, has also had an impact. DTN

and BR alone, account for almost 80 percent of all activity in Colombia's RP markets. Beyond this, the nature of repo contracts (known as "repo", "simultanea" or "fondeo abierto") themselves are not adequately harmonized. Tax, accounting, and legal uncertainties also have hindered repo market development. Finally, the absence of money market cash instruments also hinders the development of safe and sound hedging markets given that derivative contracts must be settled with cash prices which are reliable and have integrity.

251. In the near term, immediate priority needs to be given to the development of the RP markets. Actions would include: fostering adoption of a master repo agreement, harmonization of market conventions (e.g. haircuts); and efforts to clarify the tax, accounting, and legal framework for repo's. Subject to a number of considerations, including the conservation of human resources in the Ministry of Finance, and the need to assure more effective day-to-day monetary policy, consideration might be given to a gradual transfer of government cash holdings into the Central Bank account. Such a transfer could help reduce the presence of the public sector in the RP markets, and allow for a more even distribution of liquidity, given the very restrictive counterpart policies that the DTN must employ.

252. In the medium term there a new approach to the short-term T-bill market is warranted. There is a need to establish a revolving T-bill program of significant size in maturities of 90, 180, and 360 days. This is not just a question of lifting the issuance limits for T-bills set by the BR (the "cupo"), based on arguments relating to the avoidance of refinancing risk and crowding out, but on changing the current incentives of the DTN to develop this market. As noted, the DTN is a net placer of funds in the money markets and seen in isolation, this funding source is not needed. Although implementation of a T-bill program may reduce duration of the debt and increase refinancing risk, it can substantially help in reducing the interest-rate risks being transferred to the so-called money market funds.

253. When coupled with regulatory reforms applicable to the funds so as to distinguish a money market mutual fund from other funds in terms of the liquidity and duration of the assets, it is clear that these entities would be the natural buyers of short term securities. The claim that issuance of T-bills will crowd out private issuers from the market by possibly inhibiting the use of CDTs and other bank liabilities that make up the deposit (DTF) rate, seems questionable. This is because the vast majority of funds are in effect owned and operated by Fiduciaries or management companies which are themselves part of banks. It is also clear that at times the T-bill cut off rate may exceed the DTF rate. In this context it is important to point out that at times the RP rates of the Central Bank have exceeded the DTF rate.

254. First, in the near term there is a need to introduce a package of measures relating to the capital regime, risk management guidelines and reporting practices while continuing to strengthen and broaden the valuation framework. The SV started with the issuance of new capital regulations for independent broker dealers that corrects problems with the definition of capital and also imposes risk related capital requirements. This, coupled with other changes in the regulatory framework, will also lead to improvements in the solvency of primary dealers. For funds, actions are being taken to assure that there will be timely reporting of interest rate risks for all types of funds. For credit entities this information has been available since January 2002.

255. Second, measures are being prepared to improve surveillance of trading and self-regulatory organizations such as BVC, MEC, DECEVAL, SEN, and DCV. Such actions are intended to improve the integrity of asset pricing data and of information relating to underlying securities in

custody. To improve surveillance, inspections and enforcement for credit and other institutions, the BR, SB, and SV are considering expanding agreements (MoUs), which will permit development of a more unified and coordinated approach. Deploying the capacity and specialized knowledge available within the BR via use of such staff in surveillance and inspections, can strengthen these functions rapidly. The nature of disclosures made by different types of funds, in such areas as investment policies and risks, valuation of units offered, fees, etc., are all being revised to allow for more effective discipline and monitoring by the market.

Finally, over the longer term, the professionalization of the securities and financial services industry needs to be continued and strengthened. More stringent certification processes for such areas as trading, asset management, brokers/dealers, sales of securities and others, need to be considered. The success in improving the ability of the private sector to bear more risk will also be a function of the types of instruments they will have available to invest in. This will, in turn, depend on the progress made in development of all segments of the public debt market including the T-bills as well as repos. Consistent with this, a special review is needed of all investment regulations applicable to end investors including the many forms of funds. Special hedging instruments, such as derivatives traded over the counter or on the exchange, will become relevant once the liquidity of the cash markets is improved and when indices with integrity are developed with which to settle such contracts.

DETAIL OF ACTUAL REFORMS AND POTENTIAL PROPOSALS COMPRISING THE ONGOING POLICY DIALOGUE WITH THE GOVERNMENT UNDER THE MEDIUM TERM PROGRAM

INITIAL REFORMS	SUBSEQUENT REFORMS UNDER DISCUSSION/CONSIDERATION
Banking Regulation and Supervision *Approval of major reforms to the Financial System Law* *New Financial System Law enacted including reforms for (a) ensuring bank board independence and strengthening the code of conduct for managers and directors, (b) a sanctions regime regarding accountability of bank administrative officers, Board directors, auditors and other officials, (c) for the consolidated supervision of economic groups, SB's powers extended to inspect companies not directly subject to SB supervision, (d) a regime established for conflict of interest breaches involving operations with subsidiaries or related institutions, (e) clarity is made regarding SB's powers to impose penalties for non compliance with previously issued SB instructions to financial institutions, and (f) SB autonomy is granted in taking regulatory action including bank interventions and application of sanctions* *Bank boards required to approve by unanimity, any lending or deposit taking transactions with shareholders and their relatives, exceeding 5% of bank ownership An article requiring information transparency and disclosure to clients, by credit institutions is established in the new law Authority is given to SB to evaluate investments of all financial institutions' capital abroad The institutional function of 'client advocate' is legislated* The SB has formally initiated the development of a Strategic Plan including upgraded supervisory processes and policies, manuals and procedures, risk rating methodologies to assess entities, and increased capacity to recruit, train, compensate and retain bank examiners under a sustainable career program *The normative classification of cooperative credit institutions is adjusted to clarify SB supervisory authority including licensing over those institutions accepting deposits from 3rd parties (i e , non members or the public). Regulation implemented requiring cooperatives to maintain a liquidity fund* *The SB has (a) updated regulations to enhance mandatory anti-money laundering systems in the financial sector, and (b) issued regulations requiring financial institutions to directly submit information on transactions in cash to the MoF's Anti-Money Laundering monitoring Unit* *The regulatory authority of the Central Bank, in the areas of large payment system transactions, is confirmed via the modification of the financial system law. SB given powers to supervise credit and debit card companies* SB initiates a program to appraise opportunities to rationalize regulatory reports and reduce regulatory costs	**Banking Regulation and Supervision** Progress achieved in the full implementation and regulatory enforcement of the Financial System Law Decrees for implementing the financial reform law are adopted, and circulars are issued by the SB including amendments to adapt existing regulations for the supervision of financial conglomerates and group related parties, to international standards A settlement window of lower cost and earlier in the daily clearing and settlement cycle is designed to prevent bunching and default risk As a result of a program initiated by the SB, measures are adopted to reduce regulatory costs imposed by the SB's information disclosure requirements, as necessary The application and enforcement of the financial system law is achieved via demonstrative actions such as: (a) integration in the sequencing of prompt corrective actions, cease & desist orders, directives, and pecuniary sanctions within an internally consistent framework, and (b) development of procedures and handbooks by the SB relating to enforcement, remedial actions and graduated sanctions The effectiveness of supervision is improved via progress on benchmarks under the SB's 2003-06 Strategic Plan such as implementing (i) risk ratings for institutions in the financial system, (ii) consolidated examination of a major financial group, (iii) implementation of remedies, (iv) dissemination of best standards for internal governance, risk management and internal controls, and (v) approval of SB investments under its development program A policy options paper is issued with recommendations of reform for the financial transactions tax and other compulsory regulations, addressing distortionary effects on the financial system.
Banking Resolution *Regulations issued to improve compulsory procedures for asset and liability transfer and 'carve-outs' from failing institutions, through securitization of such assets utilizing trust mechanisms Measures include incorporation of additional guarantees by FOGAFIN under asset transfers, complemented with use of deposit insurance funds and bonds raised in the financial market A new intervention tool (progressive carve-outs) is included to permit voluntary liquidation of financial institutions, protect savers and investors* MoF, issues a letter of commitment and a directive to undertake a stocktaking review of financial sector stability since the crisis, including risks of weak institutions under low growth scenarios, banking sector actual cash flows, government debt market expansion (and associated fiscal risks to banks), and	**Banking Resolution** A financial sector stability review to assess future banking system health using projections for future growth, effect on bank cash flows, and risks of the government debt market, is completed, and policy recommendations and actions including reinforcement of resolution strategies under a contingency plan approved

DETAIL OF ACTUAL REFORMS AND POTENTIAL PROPOSALS COMPRISING THE ONGOING POLICY DIALOGUE WITH THE GOVERNMENT UNDER THE MEDIUM TERM PROGRAM

INITIAL REFORMS	SUBSEQUENT REFORMS UNDER DISCUSSION/CONSIDERATION
contingency plans to resolve or address potentially adverse developments *Legal authorization given to CISA to use policy tools to have asset disposition accelerated and channeled via asset sales, securitization or other mechanisms CISA is legally authorized to take on enhanced asset management and trustee functions for transfers of assets and liabilities from failing institutions and may administer such assets and liabilities under management contracts Banks and fiduciary companies are permitted to offer, respectively, asset administration and trust arrangements to conduct loan portfolio management for banks under liquidation.* *Legal authorization given for deposit insurance coverage to be made more flexible and allow exclusion of co-insurance deductible, so as to protect good faith depositors. Ex-post risk-based rebates implemented under the deposit insurance premium structure* *Formal approval given for IFI to undertake 2nd tier operations only, and operate under a private legal framework For some key State banks (IFI and Banco Agrario), lending rates and/or budget transfers by law must fully cover all operational and financial costs* *Approval of (a) the transfer of selected assets and liabilities of IFI and selected operations and administrative functions for absorption into Bancoldex, and liquidation of IFI's remaining assets, and (b) authorized both the privatization of Bancafé and the contracting of an investment firm to manage the privatization process*	Actions completed in the divestment and/or dismantling of insolvent State banks
Housing Finance *Enactment of a new Civil Procedures Code to streamline foreclosure related judicial procedures to obtain mortgage credit collateral in a more timely manner. Under the financial system reform law, the Borrower has also issued regulations to (a) extend micro credit to the housing sector for underserved segments of the Borrower's population, (b) permit banks to operate in the housing lease markets as well as in the housing micro credit market, and (c) allow finance companies to fund micro credit operations with credit lines from commercial banks* *Under the financial system reform law, leasing operations are facilitated as a new housing finance instrument and as a remedy to cases of delinquent mortgage loans Second tier State banks are permitted to rediscount leasing operations to the private banking sector* *Operational guidelines issued for (a) a new swap program to protect mortgage lenders against inflation risk, applied to the next 40,000 eligible housing loans directly contracted by Fogafin with eligible borrowers, through partner lending institutions, and managed for risk using reserves and hedging instruments, and (b) allowing the FRECH program's accumulated liquid funds to be deployed for use in swapping mortgage securities into treasury securities (which can be used with repo contracts) following established pricing rules* *Actuarial assessment completed for the revision of the guarantee program for VIS mortgage securities*	**Housing Finance** Reform of FRECH implemented according to the results of a study led by a working group, in order to become a more effective hedging tool for banks exposed to market risks Assessment made of the temporary UVR swap program and proposed reforms in regards of its capacity to restore trust of the mortgage demand, and its efficiency, equitability and fiscal management as a housing policy tool Progress is achieved in increasing the competitiveness of the mortgage industry and the affordability of new loans with policies such as (i) licensing of competing mortgage lenders requiring a specific regulatory framework for non-depository institutions, (ii) separating fees charged for externalized services related to mortgage lending, and (iii) development of a regulatory framework to better inform mortgage borrowers Regulations of secondary mortgage markets are improved according to international best practices including measures such as (i) harmonized regulations applied to securitization companies and credit institutions for risk-adjusted capital adequacy taking into account rating differences for each tranche in mortgage securities, (ii) improved oversight of securitization companies, (iii) simplified regulations for mortgage bonds, (iv) adjustment of valuation methodologies to mortgage securities' characteristics (cash-flows, callable options, UVR), and (v) inclusion of securitization companies as repo market participants Study is led by MoF to assess the tax treatment of the overall mortgage finance industry, and proposing measures to make it more progressive and efficient (for households, investors, lenders, government) Operational procedures and methodologies improved for securitization of risky assets from non-performing mortgage loans (structuring agents, rating agencies) Alternatives developed for the lack of liquidity attached to UVR-indexed mortgage securities

DETAIL OF ACTUAL REFORMS AND POTENTIAL PROPOSALS COMPRISING THE ONGOING POLICY DIALOGUE WITH THE GOVERNMENT UNDER THE MEDIUM TERM PROGRAM

INITIAL REFORMS	SUBSEQUENT REFORMS UNDER DISCUSSION/CONSIDERATION
	Improved infrastructure for the development of micro-finance, applied to housing Creation of a national housing information center (e g , at Dane) capable of collecting reliable data from multiple sources, conduct surveys and provide information on a cost recovery basis, on housing markets and prices, particularly useful for mortgage lenders, borrowing households, securitization companies, investors, real estate professionals, financial regulators, rating agencies, housing policy makers
Insurance Sector and Non Banks *Regulations issued providing for. (a) flexible regulatory powers for overseeing the insurance industry with respect the establishment of solvency margins and technical reserves, (b) an increase in the minimum capital requirement for insurers and reinsurers in line with international standards, and (c) establishing separate capital requirements for the different lines of insurance (property, life, accident, etc)* *A formal proposal is presented by the SB to MoF regarding differential solvency ratios by line* *An insurance sector regulatory framework diagnostic is completed by an independent consultant, including review of prudential standards and regulations and review of IAIS core principles in the insurance industry, for government consideration* *SB authorized to supervise representation offices of foreign reinsurance companies, and SB arranges a register of reinsurance companies and representation offices of overseas reinsurance companies that operate in the Colombian market.* A formal policy proposal is presented to MoF making more flexible the insurance investment regime for funding technical reserves. A schedule of sanctions is established for breaches of minimum solvency requirements or in the required level of insurance reserves. *The commissions structure of Investment Trust Funds is normalized to discount management fees as an expense of the managed fund* *For invested Trust Funds, a regulation replaces the specified limits on investment instruments, with internal investment risk management systems subject to non objection by the SB*	**Insurance Sector and Non Banks** The new insurance risk based solvency regulations are phased into practice in a manner that ensures full acceptance and absorption by the sector, based on progress in industry and supervisory actuarial and risk management capacity The SB sets up working groups to develop methodologies and adopt measures to manage risk in the insurance industry in accordance with IAIS international guidelines and future adopted standards. Progress is achieved in the implementation or modification of insurance regulations such as. (a) upgrading solvency margin standards and methodologies, including provisions for market risks, (b) norms to upgrade the calculation of technical reserves for unearned premiums, (c) methodologies for calculating mathematical provisions and mortality tables in the life branch to include known changes in mortality rates or interest rate changes, and (d) aligning the technical discount rate to long term market comparators to calibrate premium levels and reserve requirements Advances made in regulations to restrict "fronting" operations whereby registered primary insurers retain little or no underwriting risk. Review of regulation for the pensions/retirement annuity market offered by the insurance industry, including actuarial and pricing methodologies, is done and new regulation issued as necessary Progress is made in upgrading regulations for catastrophic risk reserves to allow their utilization for major events, with reserve replenishments achieved according to a graduated schedule Progress made in updating accounting norms for reinsurance contracts to recognize finite/financial reinsurance treaties as contracts without full risk transfer characteristics Industry perceived regulatory obstacles reviewed,as pertaining to fiduciary trust companies, including application of financial transactions tax, sales tax on commission revenues, capital requirements, min./max limits on allowable managed funds for individual parties, and management of venture or small enterprise investment funds Progress is made in regulatory developments specifying value at risk (VAR) and duration gap methodologies for measuring risk, and applied to AFPs and Trusts Using VAR methodologies, the AFP portfolio benchmark is modified to reflect market dynamics such as market risk and actual investment opportunities. The AFP fund limit for investing in foreign securities is reviewed for consideration of regulatory change Regulations on SB filings required from Trusts and AFPs are simplified to reduced regulatory costs to the industry

DETAIL OF ACTUAL REFORMS AND POTENTIAL PROPOSALS COMPRISING THE ONGOING POLICY DIALOGUE WITH THE GOVERNMENT UNDER THE MEDIUM TERM PROGRAM

INITIAL REFORMS	SUBSEQUENT REFORMS UNDER DISCUSSION/CONSIDERATION
The Capital Markets *The SV, the SB and the Central Bank have issued a common securities and financial asset valuation methodology for unifying mark-to-market regulations. A memorandum of understanding has been signed between the SV and the SB to harmonize the regulatory framework for collective funds, prudential regulation, and joint activities of supervision between the two institutions* *Valuation standards for treasury securities and external debt securities are established* *Regulation on norms governing broker/dealer investment proprietary positions, capital at risk, regulatory capital for own positions, is presented for consultation with the market* *The SV is reorganized in order to create a mutual funds division, and intermediaries and markets division (to regulate entry and exit), and a supervision division (focused on surveillance and enforcement)*	**The Capital Markets** A New Securities Law is presented to Congress for approval and includes: a New corporate governance norms including the role of the Board, management, auditors, and others b Securities issuance norms and disclosure requirements with rationalized procedures for issuance. c Qualification of standards for industry professionals and entrants d Regulations for public market issuance and private placements. e Graduated sanctions and penalty schedules f Establishing effective checks and balances within the mutual funds industry, g. Regulatory environment for investment banks and licensing h. Security transaction netting, use of repos, and a central counterparty risk facility i New issues of securities are dematerialized and managed as book entry in electronic custody j Uniform rules for borrowing and lending of securities. k Licensing of relevant activities and functions l. Improvement in negotiation and trading systems to increase transparency and price formation A common regulatory and supervisory framework for the mutual funds and investment funds industry is established Fiduciary Trust institutions and specialized investment funds under SB's supervision, and mutual funds under SV's supervision, are placed under a uniform framework. Risk management strengthened through requirements to calculate VaR for funds of fiduciaries, pension funds, insurance companies, and mutual funds administered by institutions regulated by the SV. Common monitoring system for risk management of financial and securities entities is established between the SB and SV To prevent payment system risks, contractual obligations under repo transactions (the full cycle covered) are legislated as being fully legally binding and equivalent to separate but simultaneous contracts for the initial exchange of assets for a short term loan and the repurchase of assets with repayment of the loan. The SV is modernized and reengineered to improve market monitoring systems, self regulation of exchanges, clearance and settlement systems, regulatory coordination with SB, development of operational manuals, and strengthening of technical skills for surveillance and enforcement of market activities
The Government Debt and Money Markets *To improve the government securities market, (a) the Central Bank's Board has issued regulations allowing said institution to purchase on-the-run securities (i e securities in a specific maturity range most recently issued by the Treasury or open for issue), (b) the SV has issued revised regulations for Primary Dealer operations, and (c) the MoF has issued a regulation for valuation of domestic Treasury securities* *Valuation committee established under MoU signed between SV and SB*	**The Government Debt and Money Markets** Debt management committee established to set policy within a medium term framework. Issuance strategy for government debt developed and discussed by debt management committee Guidelines for valuation of other public securities and private fixed income instruments implemented Progress is made in adopting neasures to enhance the efficiency of the repo market (and borrowing and lending of securities). Progress is made in implementing a new collateral system for BR operations Progress is achieved in implementing regulations/circulars clarifying the accounting treatment for forced investments

Annex 7: Timetable of Key Processing Events

Time taken to Prepare: (Identification to Negotiations)	9 months
Prepared by:	Government and World Bank Staff
Identification Mission Departure:	November 12, 2002
Preparation Mission	January 20, 2003
Management Review Meeting	March 6, 2003
Regional Operations Committee	March 17, 2003
Appraisal:	March 24-26, 2003
Negotiations:	March 27, 2003
Board Presentation:	April 24, 2003
Planned Date of Effectiveness:	April 27, 2003
Closing Date:	December 31, 2003

Annex 8

COLOMBIA: FUND RELATIONS NOTE

Public Information Notice (PIN) No. 03/09
January 23, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

Colombia: Public Information Notice

On January 15, 2003 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Colombia.[13]

Background

The Colombian economy has staged a steady, albeit slow recovery since the 1998-99 crisis. Macroeconomic stabilization has been achieved, and robust fiscal and structural policies during most of the period since then have allowed the country to avoid some of the difficulties faced by other economies in the region. This is all the more remarkable since Colombia also has had to contend with a costly internal conflict that disrupts economic processes and distorts resource allocation.

However, the economic situation worsened in the first half of 2002. Peace negotiations with the guerillas broke down in February, after which violence escalated. Economic activity has remained sluggish, and the fiscal consolidation has gone off track. Exacerbated by increased contagion from other countries in the region, concerns about fiscal solvency led to increased pressure on the peso from mid-year and a loss of external market access.

After taking office in August 2002, a new administration took determined action to quicken a resolution of the internal conflict, reverse the fiscal deterioration, and safeguard macroeconomic stability, which had come under threat. At the same time, a two-year economic program has been designed, under which the government aims to achieve fiscal consolidation and effect critical structural reforms, so as to lay the basis for strong and sustained growth and a better distribution of income and social services.

[13] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the January 15, 2003 Executive Board discussion based on the staff report.

Executive Board Assessment

Directors commended the new government's swift and comprehensive action to face a difficult domestic and external situation. A deterioration in the domestic security situation last year, together with the turbulence in international financial markets and a weakening of the public finances, had exerted pressure on the peso and had resulted in a temporary loss of market access. Directors strongly welcomed the new government's rapid and determined actions to reverse the fiscal slippages and safeguard macroeconomic stability, advance institutional and economic reforms, and accelerate resolution of the internal conflict. In particular, Directors were encouraged by the measures already taken, and the strong domestic ownership in support of further reforms, that will allow Colombia to lastingly improve its debt dynamics and prospects for growth and employment. They saw Colombia's recent return to the capital markets as a recognition of the improved economic policies and the reform momentum created by the government.

Directors supported the authorities' plan to reduce the fiscal deficit sharply in 2003–04 and welcomed their commitment to take the measures needed to ensure public debt sustainability. In particular, they welcomed the recent passage of tax reform that will help underpin the lower deficit, as well as the effort to mobilize broad public support for spending measures. While the program provides for fiscal consolidation to continue over the medium term, it will, nevertheless, remain important that the authorities stand ready to take additional measures, as needed, to address risks that could affect the public finances, including those from security-related spending. Directors welcomed the government's commitment and preparedness to take action in this regard. Looking ahead, they saw a need for further efforts to strengthen the tax base. This would include a reduction in the dispersion of VAT-rates, while, over the medium-term, efforts should aim at alleviating the need to resort to ad-hoc measures, such as the financial transaction tax.

Directors supported the authorities' decision to finance the fiscal program for 2003 entirely from the domestic market and from increased borrowing from multilateral lenders. They underscored the importance of advancing the structural reforms that will help secure this multilateral financing. Directors also noted the efforts underway to reduce the vulnerability of Colombia's debt structure. Going forward, it will remain important to continue to implement policies aimed at reducing the vulnerability of the public debt to shocks, which will require, in addition to fiscal consolidation, the pursuit of sound policies that help avoid volatility of exchange and interest rates. A few Directors encouraged the authorities to introduce collective action clauses in sovereign bond contracts.

Directors were encouraged by the authorities' commitment to wide-ranging structural reforms, which will be key to underpin the fiscal consolidation effort over the medium term. They welcomed the recent approval in congress of the reform of the general pension system, and looked forward to the next step, which will include reform of the special pension regimes. They also highlighted the importance of reforms to put the health system on a sound financial footing. Directors supported the high priority assigned by the new administration to modernizing and streamlining the state and introducing greater flexibility in public spending. They looked forward to sustained implementation

of reform plans in these areas, building on the ongoing initiatives to close existing vacancies and reduce staffing through attrition, and the impending adoption of a Fiscal Responsibility and Transparency Law.

Turning to monetary policy, Directors commended the central bank for the high credibility that it has established after having presided over a period of significant disinflation. They noted that the continued skilful management of the inflation targeting framework in the period ahead will need to balance carefully the risk that the recent peso depreciation may fuel higher inflation against the still large unused capacity in the economy. In this regard, Directors recommended that the authorities should be ready to act promptly to signs that inflationary expectations could become embedded. Some Directors expressed concern that the central bank's policy rate is negative in real terms.

Directors welcomed the significant progress achieved in strengthening the banking system, including the recent legislation to further strengthen the safeguards, and the authorities' commitment to refrain from introducing new subsidy programs for distressed borrowers. They recommended continued vigilance in the period ahead, especially with respect to the mortgage institutions, and encouraged the authorities to strengthen the regulation of securities firms and brokerages. Directors commended the authorities for their exemplary and comprehensive efforts to combat money laundering and the financing of terrorism, and encouraged continued efforts against terrorist assets.

Directors emphasized that increased labor market flexibility will be key to address Colombia's high unemployment and support the government's social equity objectives. While welcoming the recent reform of the labor code, they encouraged the authorities to continue to work toward addressing remaining problems, in particular the backward indexation of the minimum wage and the high payroll charges, which tend to exclude workers from the formal sector.

Directors considered that Colombia's floating exchange rate regime was appropriate and had helped strengthen the country's ability to respond to shocks, and that Colombia's increasingly diversified exports are competitive at the current exchange rate. They commended the authorities for progress in liberalizing the trade regime and encouraged them to phase out remaining import restrictions. A number of Directors underscored the improved export prospects that Colombia would gain from faster trade liberalization by its trading partners.

Directors encouraged the authorities to accept the obligations of Article VIII of the Fund's Articles of Agreement as soon as possible, and eliminate the few remaining exchange restrictions.

For questions please contact Mr. R. Rennhack, Division Chief, South/Central American, Western Hemisphere Department, IMF, ext. 37350.

Annex 9

Colombia

Status of World Bank Operations

(US$ Millions)

Colombia: IBRD Operations as of January 31, 2003

Project	Loan Amount	Disbursed	Approved	Closing
AGRICULTURE TECHNOLOGY	51.00	45.04	20-Apr-95	31-Dec-03
SANTAFE I (WATER/SUPPLY)	58.00	45.20	16-Nov-95	30-Jun-03
SANTAFE I (WATER/SUPPLY)	87.00	64.84	16-Nov-95	30-Jun-03
URBAN ENVIRONMENT TA (TAL)	20.00	18.57	16-Jan-96	31-Dec-02
REGULATORY REFORM T.A.	12.50	9.51	25-Feb-97	30-Jun-03
CO FINANCIAL MARKETS DEVELOPMENT	15.00	7.66	20-Jun-97	31-Dec-03
CO PASTO EDUCATION	7.20	4.90	6-Nov-97	30-Jun-03
CO ANTIOQUIA EDUCATION	40.00	30.32	6-Nov-97	30-Jun-03
CO URBAN INFRASTRUCTURE	75.00	35.68	11-Jun-98	30-Jun-04
PEASANT ENTERPRISE ZONES (LIL)	5.00	2.97	26-Jun-98	31-Dec-03
CARTAGENA WATER SUPPLY & SEWERAGE	85.00	22.11	20-Jul-99	31-Dec-04
CO RURAL EDUCATION	20.00	3.07	11-Apr-00	30-Jun-04
SIERRA NEVADA SUSTAINABLE DEVELOPMENT	5.00	1.76	2-May-00	15-Dec-05
CO- COMMUNITY WORKS (MANOS A LA OBRA)	100.00	20.60	11-May-00	30-Nov-03
CO PUBLIC FINANC. MANAGEMENT PROJECT II	35.47	2.68	22-Mar-01	31-Oct-06
CO- HUMAN CAPITAL PROT.- CASH TRANSFERS	150.00	28.06	29-Mar-01	31-Dec-04
CO WATER SECTOR REF ASSISTANCE PROJECT	40.00	2.16	25-Oct-01	30-Jun-07
2ND MAGDALENA MEDIO PROJECT (LIL)	5.00	2.78	27-Sep-01	28-Feb-04
CO JUDICIAL RESOLUTION IMPROVEMENT PRJ.	5.00	0.55	8-Nov-01	30-Jun-05
CO STRUCTURAL FISCAL ADJUSTMENT LOAN	400.00	340.00	18-Dec-01	31-Mar-03
CO PRODUCTIVE PARTNERSHIPS	32.00	2.90	22-Jan-02	30-Sep-07
PRIVATE SECTOR INFRASTRUCTURE FINANCE	2.00	1.72	13-Feb-95	31-Oct-98
CO-HIGHER EDUCATION - IMPROVING ACCESS	0.09	0.09	9-Oct-01	21-May-03
TOTAL	1,250	693		

Annex 10

Colombia
Statement of IFC's
Held and Disbursed Portfolio
As of June 30, 2002
(In US Dollars Millions)

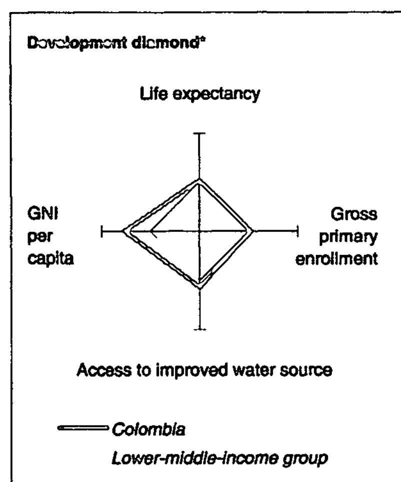
		Held				Disbursed			
FY Approval	**Company**	**Loan**	**Equity**	**Quasi**	**Partic.**	**Loan**	**Equity**	**Quasi**	**Partic.**
2002	BCSC	0.0	7.0	0.0	0.0	0.0	0.0	0.0	0.0
2002	Bavaria	70.0	0.0	30.0	0.0	0.0	0.0	0.0	0.0
1969/85/88/93/95	CF del Valle	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2001	CHMC	0.0	10.6	0.0	0.0	0.0	4.0	0.0	0.0
1974/01	Cementos Caribe	4.1	10.0	0.0	13.0	4.1	10.0	0.0	13.0
1963/90	Coltejer	6.0	0.0	0.0	0.0	6.0	0.0	0.0	0.0
1995/99	Corfinsura	25.0	1.5	23.5	0.0	0.0	1.5	23.5	0.0
2002	Inversura	0.0	15.0	0.0	0.0	0.0	0.0	0.0	0.0
1987	PRODESAL	0.0	0.6	0.0	0.0	0.0	0.6	0.0	0.0
1977/89/92/94/96	Promigas	5.0	0.0	0.0	8.3	5.0	0.0	0.0	8.3
0/94/95	Promisan	0.0	0.2	0.0	0.0	0.0	0.2	0.0	0.0
?002	Proteccion	0.0	10.0	0.0	0.0	0.0	0.0	0.0	0.0
1996	Proyectos	0.0	5.0	0.0	0.0	0.0	5.0	0.0	0.0
2002	SIG	75.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1999	Surenting	0.0	5.1	0.0	0.0	0.0	2.5	0.0	0.0
2001	Tolcemento	3.3	0.0	0.0	10.7	0.0	0.0	0.0	0.0
	Total Portfolio:	188.4	65.0	53.5	32.0	15.1	23.8	23.5	21.3

Approvals Pending Commitment (US$ '000)

		Loan	Equity	Quasi	Partic.
2001	CCGF	-	19.0	-	-
2002	Bavaria	-	-	-	200.0
2002	Omimex Oil	30.0	-	5.0	-
2001	CHMC	-	19.4	10.0	-
	Total Pending Commitment	30.0	38.4	15.0	200.0

Colombia at a glance

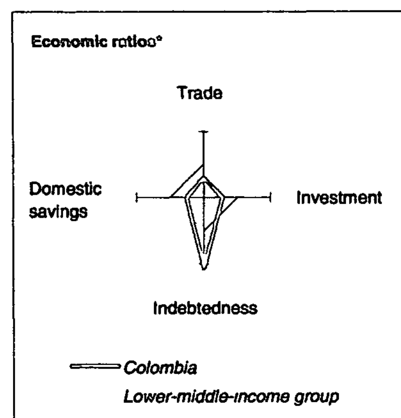
POVERTY and SOCIAL	Colombia	Latin America & Carib.	Lower-middle-income
2001			
Population, mid-year *(millions)*	43.0	524	2,164
GNI per capita *(Atlas method, US$)*	1,890	3,560	1,240
GNI *(Atlas method, US$ billions)*	81.5	1,862	2,677
Average annual growth, 1995-01			
Population *(%)*	1.8	1.5	1.0
Labor force *(%)*	2.7	2.2	1.2
Most recent estimate (latest year available, 1995-01)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	75	76	46
Life expectancy at birth *(years)*	72	70	69
Infant mortality *(per 1,000 live births)*	20	29	33
Child malnutrition *(% of children under 5)*	7	9	11
Access to an improved water source *(% of population)*	91	85	80
Illiteracy *(% of population age 15+)*	8	11	15
Gross primary enrollment *(% of school-age population)*	112	130	107
Male	112	131	107
Female	112	128	107



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

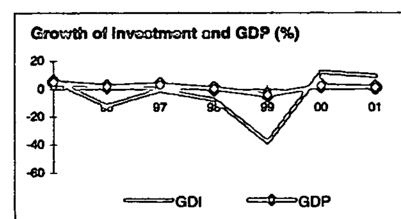
	1981	1991	2000	2001
GDP *(US$ billions)*	38.4	41.5	83.2	82.4
Gross domestic investment/GDP	20.6	15.9	13.4	14.9
Exports of goods and services/GDP	11.9	21.3	19.9	19.4
Gross domestic savings/GDP	17.0	23.4	13.7	15.3
Gross national savings/GDP	16.5	23.1	12.3	14.3
Current account balance/GDP	-4.7	5.7	0.4	-2.2
Interest payments/GDP	1.3	3.4	2.5	2.5
Total debt/GDP	24.0	41.5	41.0	45.1
Total debt service/exports	20.7	36.3	29.9	..
Present value of debt/GDP	..	..	40.2	..
Present value of debt/exports	..	..	193.7	..

	1981-91	1991-01	2000	2001	2001-05
(average annual growth)					
GDP	3.8	2.5	2.6	1.4	2.3
GDP per capita	1.7	0.6	0.7	-0.3	0.6
Exports of goods and services	9.4	4.8	3.3	4.1	2.5

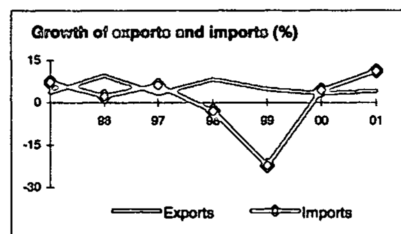


STRUCTURE of the ECONOMY

	1981	1991	2000	2001
(% of GDP)				
Agriculture	19.8	17.4	13.4	13.0
Industry	31.5	37.1	30.1	29.9
Manufacturing	21.9	20.9	15.9	16.3
Services	48.7	45.4	56.5	57.1
Private consumption	72.5	67.4	64.6	63.6
General government consumption	10.4	9.2	21.8	21.1
Imports of goods and services	15.4	13.9	19 6	19.0



	1981-91	1991-01	2000	2001
(average annual growth)				
Agriculture	3.3	-1.8	4.7	0.1
Industry	5.2	1.2	4.4	-0.1
Manufacturing	3.9	-2 1	10.5	-0.8
Services	3.2	3.8	1.2	2.1
Private consumption	2.8	1.9	2.6	1.9
General government consumption	4.4	9.6	-2.1	0.3
Gross domestic investment	0.6	-0.3	12 3	9.6
Imports of goods and services	0.8	6.3	4.4	11.2



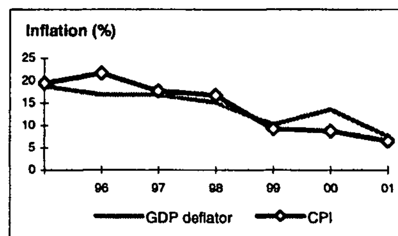
Note. 2001 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Colombia

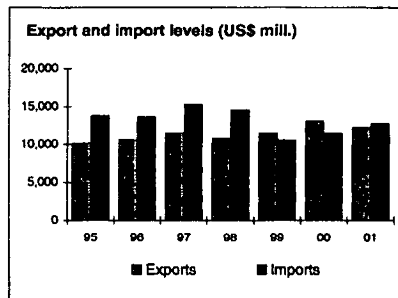
PRICES and GOVERNMENT FINANCE

	1981	1991	2000	2001
Domestic prices				
(% change)				
Consumer prices	27 3	26.8	8 7	6 5
Implicit GDP deflator	22.8	26 0	13 6	7 6
Government finance				
(% of GDP, includes current grants)				
Current revenue		14.1	11.8	13.3
Current budget balance	..	4.8	-5 2	-5.0
Overall surplus/deficit	.	2 6	-6 0	-6.1



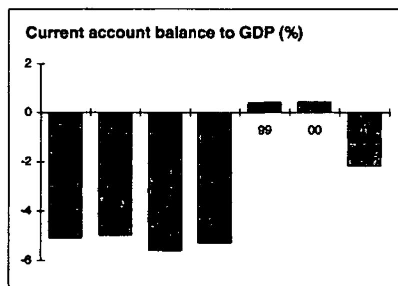
TRADE

	1981	1991	2000	2001
(US$ millions)				
Total exports (fob)	3,195	7,653	13,115	12,309
Coffee	1,423	1,336	1,069	764
Petroleum	36	1,460	4,569	3,083
Manufactures	928	2,400	5,190	5,606
Total imports (cif)	5,199	4,963	11,538	12,834
Food	319	280	1,428	1,578
Fuel and energy	726	284	234	189
Capital goods	1,859	1,565	3,414	4,468
Export price index *(1995=100)*	8	59	247	243
Import price index *(1995=100)*	7	63	193	209
Terms of trade *(1995=100)*	118	94	128	116



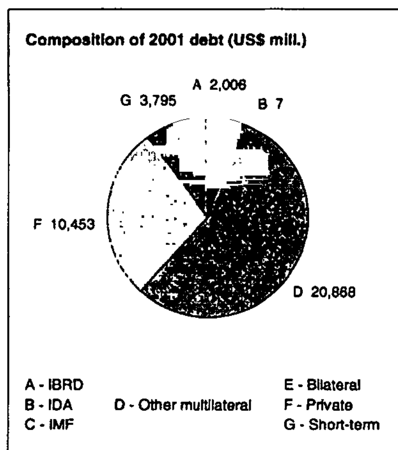
BALANCE of PAYMENTS

	1981	1991	2000	2001
(US$ millions)				
Exports of goods and services	4,678	9,115	15,624	14,932
Imports of goods and services	6,215	6,633	14,400	15,840
Resource balance	-1,537	2,482	1,224	-908
Net income	-427	-1,832	-2,530	-2,975
Net current transfers	243	1,697	1,662	2,094
Current account balance	-1,721	2,347	356	-1,789
Financing items (net)	1,284	-298	513	2,955
Changes in net reserves	437	-2,049	-869	-1,166
Memo:				
Reserves including gold *(US$ millions)*	..	..	9,006	10,245
Conversion rate *(DEC, local/US$)*	54.5	629.3	2,087.6	2,299.8



EXTERNAL DEBT and RESOURCE FLOWS

	1981	1991	2000	2001
(US$ millions)				
Total debt outstanding and disbursed	8,716	17,201	34,081	37,129
IBRD	1,164	3,728	1,920	2,006
IDA	21	14	7	7
Total debt service	1,120	3,755	5,171	
IBRD	161	798	368	365
IDA	1	1	1	1
Composition of net resource flows				
Official grants	7	68	79	
Official creditors	277	-150	102	203
Private creditors	1,127	-270	728	..
Foreign direct investment	265	457	2,376	2,328
Portfolio equity	0	0	26	3,380
World Bank program				
Commitments	0	60	350	635
Disbursements	251	301	266	368
Principal repayments	77	492	243	233
Net flows	174	-191	24	135
Interest payments	85	307	127	133
Net transfers	89	-498	-103	3

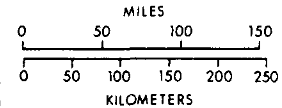


MAP SECTION

IBRD 26153

COLOMBIA

The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of The World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.



ELEVATION ABOVE 1000 METERS
NATIONAL CAPITAL
DEPARTMENT CAPITALS
RIVERS
DEPARTMENT BOUNDARIES
INTERNATIONAL BOUNDARIES

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