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IMPLEMENTATION COMPLETION REPORT
(TF-52531 FSLT-72580)

ON A

LOAN

IN THE AMOUNT OF US$100 MILLION

TO THE

REPUBLIC OF COLOMBIA

FOR A

SECOND PROGRAMMATIC FINANCIAL SECTOR ADJUSTMENT LOAN

November 10, 2005

Colombia and Mexico Country Management Unit
Finance, Private Sector and Infrastructure Department
Latin America and the Caribbean Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective November 9, 2005)

Currency Unit = Colombia Pesos
US$ 1 = 2,280.90 COP

FISCAL YEAR

January 1 December 31

ABBREVIATIONS AND ACRONYMS

AML/CTF	Anti-money laundering / Countering of terrorist financing
BANCAFE	Banco Cafetero (State-owned Bank)
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 (Bank supervision risk rating model)
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)
FEN	Financiera Energética Nacional (Government Energy Sector Bank)
FINAGRO	Fondo para Financiamiento del Sector Agropecuario (Financing Fund for the Agricultural Sector)
FINDETER	Financiera de Desarrollo Territorial (Municipal Financing Second Tier 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 (Reserve Fund for the Stabilization of the Mortgage Portfolio)
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
IFI	Instituto de Fomento Industrial (Industrial Development Bank)
MBS	Mortgage Backed Securities
MOF	Ministry of Finance (Ministerio de Hacienda y Credito Publico)
PDR	Problem Debt Restructuring
PFSAL I	First Programmatic Financial Sector Adjustment Loan, or First Loan
RP/REPO	Repurchase Market / Repurchase Operation
SARC	Sistema de Administración Riesgos de Crédito (Credit Risk Management System)
SB	Superintendencia Bancaria (Superintendency of Banks)
SEARS	Sistema Especial de Análisis de Riesgos de Seguro (Insurance Risk Management System)
SEN	Sistema Electrónico de Negociación (Electronic Trading System - Gov't Debt)
SV	Superintendencia de Valores (Securities Superintendency)
TES	Títulos de Tesorería (Treasury Bills/Notes)
UIAF	Unidad de Inteligencia y Análisis Financiero (Financial Intelligence and Análisis 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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COLOMBIA
Colombia Programmatic Financial Sector Loan II

CONTENTS

Project ID: P082597	*Project Name:* Colombia Programmatic Financial Sector Loan II
Team Leader: Constantinos A. Stephanou	*TL Unit:* LCSFF
ICR Type: Core ICR	*Report Date: November 10, 2005*

1. Project Data

Name:	Colombia Programmatic Financial Sector Loan II	*L/C/TF Number:*	TF-52531; FSLT-72580
Country/Department:	COLOMBIA	*Region:*	Latin America and the Caribbean Region

Sector/subsector: Capital markets (30%); Banking (20%); Housing finance and real estate markets (20%); Non-compulsory pensions, insurance and contractual savings (20%); Central government administration (10%)

Theme: Regulation and competition policy (P); Other financial and private sector development (P); State enterprise/bank restructuring and privatization (S); Debt management and fiscal substainability (S); Access to urban services and housing (S)

KEY DATES			*Original*	*Revised/Actual*
PCD:	07/12/2004	*Effective:*	10/04/2004	10/04/2004
Appraisal:	08/18/2004	*MTR:*		
Approval:	09/23/2004	*Closing:*	03/31/2005	03/31/2005

Borrower/Implementing Agency: Republic of Colombia/Ministry of Finance
Other Partners: Banking Superintendency, Deposit Insurance Agency, Securities Superintendency

STAFF	Current	At Appraisal
Vice President:	Pamela Cox	David de Ferranti
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2. Principal Performance Ratings

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

Outcome: S

Sustainability: L

Institutional Development Impact: SU

Bank Performance: S

Borrower Performance: HS

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

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

3.1 Original Objective:

Introduction

1. **This is the Implementation Completion Report (ICR) for the second of two Programmatic Financial Sector Adjustment Loan operations (henceforth known as the Program) in support of comprehensive sector reforms that were embarked upon by the Government of Colombia to overcome the difficulties resulting from the 1998-99 banking crisis and to achieve sound growth of the financial system**. The first Loan (PFSAL I) of US$150 million was disbursed on June 30, 2003, and the ICR was submitted on December 22, 2003. The second Loan (PFSAL II) of US$100 million was made effective and was disbursed on October 4, 2004.

2. **This ICR presents an evaluation of PFSAL II as well as an assessment of the outcome of the overall Program**. The analysis of objectives below reviews the overall Program objectives and each one of its five components. In the analysis of design, this ICR reviews the overall Program based on the cumulative experience through the second Operation, and then addresses the specific design features of PFSAL II. The Outcomes section first reviews the overall outcomes in the areas supported by the five Program components, and then evaluates the outcomes attributable to PFSAL II. The Output section addresses both PFSAL I and PFSAL II, with a greater emphasis on the latter. The principal performance ratings shown above and discussed in later sections only cover PFSAL II. The lessons learned, as well as the implementing agency (Colombian Ministry of Finance or MoF) comments, reflect the experience of the overall Program in general and of PFSAL II in particular.

3. **The Program has supported a comprehensive and relatively complex set of financial sector reforms**. In line with the Bank's overall mission, these reforms have supported financial development objectives both indirectly (i.e. a stronger prudential framework that reduces the incidence and severity of costly banking crises) and directly (i.e. greater access to finance via support of non-bank financial intermediation). The ICR provides a broad background to the macroeconomic and financial sector context at the time of the Program's origination and prior to PFSAL II (see below), and analyzes in detail the objectives, outputs and outcomes for each of the five distinct components. The Policy Matrix for the entire Program is shown in Annex 8.

Development Objectives of the Program

4. **The overall objective of the Program was to support comprehensive post-crisis financial sector reforms that were embarked upon by the Government of Colombia to overcome the difficulties resulting from the 1998-99 crisis and to achieve sound growth of the financial system**. Both the banking crisis in 1998-1999 and the government securities (*Títulos de Tesorería* or TES) market crisis in August 2002 pointed to pressure points in the financial system and underscored the need for better risk management tools and greater diversification of financial instruments, as well as for a bigger role of non-bank financial intermediaries. The specific objectives of the overall Program were:

a. to strengthen the government's capacity to manage and mitigate weaknesses in the banking system through an improved legal and regulatory framework and the implementation of modern risk management approaches to cushion future losses;

b. to complete the clean up of the banking system as a result of the 1998-2001 crisis by providing mechanisms to dispose of assets which might represent contingent liabilities of the State, and to upgrade existing mechanisms for bank resolution;

c. to strengthen and diversify the participation of non-bank financial intermediaries in the domestic money market, in housing finance, insurance services, trust and pension services and issuance and trading of securities, including the government's issuance of debt securities.

5. **The achievement of the first objective was based on the reinforcement of existing financial legislation to incorporate better standards to corporate accountability, governance and risk management as key elements in the regulatory framework**. A new financial system law would enable the supervisory agencies to establish more effective rules and regulations that would strengthen banking practices for sound growth as well as implementing modern risk management tools for financial system participants. The new regulatory standards focus on early detection in order to implement corrective actions and thus mitigate systemic weaknesses.

6. **In support of the second objective, the Government was to implement measures to dispose of the financial system's loans and other assets remaining from earlier bank interventions, while making collateral liquidation procedures and future bank resolution processes more agile and effective**. In addition, the remaining intervened banks were expected to be divested and the largest public second-tier problem bank to be wound down. Through the achievement of this objective, the Government intended to reduce its fiscal obligations and contingent liabilities which had emanated from the support it had provided to financial institutions as well as its direct stake in "officialized" banks which it needed to manage following earlier interventions.

7. **The third objective was to be supported by several initiatives to promote and strengthen sound non-bank financial intermediation**. These included the development of market risk hedging mechanisms for the mortgage sector and micro finance instruments, a liquid securitization market for primary residential mortgages, the upgrading of capital adequacy standards in the insurance sector, the deepening of the government securities market including the development of unbiased securities valuation methodologies and more effective government debt management policies, and the reform of securities legislation to promote a more agile development of the local capital market.

Macroeconomic Context

8. **At the time of the Program's preparation in early 2003, Colombia was beginning to recover from its worst recession in over sixty years, although it remained vulnerable to external shocks**. In particular, macroeconomic performance was expected to continue to improve – driven primarily by a recovery of the export sector – during the period of the Program, raising real GDP growth rate from a lackluster below 2 percent growth experienced over the previous two years (see Selected Economic Indicators table in section 10). However, it was anticipated that it would take longer for the economy to achieve its full growth potential. During the pre-crisis period of 1983-1997, real GDP growth had averaged 4.1 percent per annum, compared to the projected growth rate of 3 percent during the implementation of the Program covering 2003-2006. In addition, external vulnerability had increased as a result of a surge in domestic violence and uncertainty regarding the spread of internal conflict, a worsening of market sentiment towards Latin America, political 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). This was reflected in the significant deterioration of Colombia's sovereign debt spreads and currency in 2002, which added to the country's external debt service burden.

9. **The principal risk to the country's macroeconomic stability at that time, and thus to the sustainability of financial sector reforms, remained the large fiscal deficits and the high burden of**

public sector debt. Total public debt had almost doubled over the previous five years as a result of the combination of exchange rate depreciation and fiscal liabilities arising from the 1998 banking crisis, and had reached 60 percent of GDP by 2002. Assuming full implementation of the macroeconomic reform package, it was expected that the overall public sector deficit would fall from close to 4.0 percent of GDP in 2002, to between 2.0 - 2.5 percent during 2004-2005. In support of fiscal adjustment efforts, an IMF Stand-By Arrangement (SBA) was approved in January 2003 for a two year period. By contrast, deft management of monetary policy by the Central Bank (Banco de la Republica or BR) had facilitated a noticeable decline in inflation from 20.9 percent in 1995 to 7 percent in 2002.

10. **Colombia's macroeconomic prospects had improved considerably by the time of PFSAL II preparation in late 2004**. The economy had grown above expectations in 2003 reaching 4 percent, supported by a pick-up in global economic activity. Unemployment eased to its lowest level since the crisis, while strong capital inflows led to an appreciation of the peso and investor confidence remained high. The government continued to make progress on fiscal adjustment and met the revised target under the SBA; the combined public sector deficit narrowed to 2.7 percent of GDP, down from 3.7 percent of GDP in 2002. Financing of this deficit was facilitated by improvements in the terms on which the government could access international capital markets, with the coupon rates of Colombian dollar denominated bonds coming down from a peak of 11.75 percent in mid-2002 to 8.125 percent for a twenty-year bond issuance in early 2004. Thus the economic environment and future prospects at the time of the second Operation were more favorable for the implementation of financial sector reforms.

Status of the Financial System

11. **Following a period of aggressive expansion in the early 1990's, the Colombian financial system entered a period of substantial stress in 1998**. The adverse effects of overextension of credit were accentuated by turbulence in global financial markets following the Asian crisis and the Russian debt default. At the same time, domestic interest rates jumped in 1998 to very high levels as authorities attempted to defend the foreign exchange rate band against speculators, which intensified credit woes in the financial system. Both credit quality problems and excessive interest rate risk contributed to the weakening of the banking system. The increasing liquidity problems faced by several credit institutions eventually led to lack of compliance with minimum reserve requirements and to their intervention by the authorities.

12. **Two particularly vulnerable components of the banking system at that time were the *Corporaciones de Ahorro y Vivienda* (CAVs, or Housing Finance Banks) and the financial cooperatives**. The CAVs, later renamed *Bancos Especializados en Crédito Hipotecario* (BECHs) under the new banking law in 2003, specialized in residential mortgage lending and had built up a sizeable interest rate imbalance between their deposit liabilities that paid a nominal peso rate of interest and their mortgage loans that were indexed to the inflation rate through the UPAC (*Unidad de Poder Adquisitivo Constante*) mortgage price index. The dramatic increase in deposit interest rates in 1998 had led the government to modify the UPAC formula to incorporate both changes in interest rates and in inflation in the determination of the value of the UPAC index applied to mortgage loans. Colombia's Constitutional Court subsequently ruled against the change in the indexation mechanism and instructed banks to restate the value of mortgage loans back to the time when the original change to the UPAC index was made, applying only the inflation index to the newly named UVR (*Unidad de Valor Real*) index. The downward adjustment to the value of the banks' mortgage loans that this caused further exacerbated loan portfolio problems that were already severe after debtor defaults from rising indexed interest rates.

13. **Facing the risk of a broader systemic crisis and a run on deposits, the Government embarked on a series of economic emergency measures to address problems in the financial sector**. These measures can be conceptually divided into those aiming primarily to restore the health of the system (financial sector support operations) and those that provided support to debtors (relief or "*alivios*" and restructuring programs). The measures attempted to bring a balance between the competing interests and problems of the involved parties, and were mainly carried out by the deposit insurance and bank restructuring agency *Fondo de Garantías de Instituciones Financieras* (FOGAFIN). In sum, the government provided roughly the equivalent of 10 percent of 1999's GDP (though, as discussed later, most of this was later recovered) in support of all these initiatives to recover from the financial sector crisis. These resources were provided through budgetary allocations and by resources from the deposit insurance fund administered by FOGAFIN.

14. **Financial sector support consisted of private and public sector bank cleanup and recapitalization operations**. In the case of private banks (Resolutions 6/99 and 11/99), FOGAFIN provided a recapitalization line to credit institutions under certain preconditions relating to portfolio clean-up, partial recapitalization by their shareholders (to ensure burden sharing and incentive alignment) and the successful adoption of an adjustment plan and a new management contract. In addition to the recapitalization line, FOGAFIN lent funds to the shareholders of some private banks ("*capital garantía*") so that they could participate in the required recapitalization. Later measures included liquidity support operations in the form of bond purchases and credit portfolio repurchase agreements, as well as the extension of FOGAFIN recapitalization line, subject to similar conditions, to BECHs (Resolution 6/01). A detailed review of public sector banks also led to the decision to liquidate or restructure and eventually privatize most of these entities, with the exception of *BANCO AGRARIO*, which was to remain active in serving the largely underserved rural communities where the private sector could not efficiently provide financial services. FOGAFIN assumed direct control of public banks in order to dispose of unproductive assets, restructure, sell or liquidate these entities, and of those private ones deemed necessary to be "officialized" as part of the recapitalization process.

15. **In addition to promoting the use of loan restructuring agreements for viable enterprises (Law 550/99), debtor relief primarily focused on mortgage borrowers.** Following the adoption of Decree 2331 in November 1998, relief to the most vulnerable groups affected by the crisis – mainly low income mortgage borrowers and depositors in the financial cooperatives system – was provided by FOGAFIN in two phases. *Alivios 1* provided credit at subsidized rates to mortgage debtors in order to reduce their debt levels with the financial institutions. *Alivios 2* (Decree 688 of April 1999) constituted an extension and expansion of the first phase.

16. **During the same period, the *Superintendencia Bancaria* (SB) also undertook a host of measures to strengthen the financial system**. Resolutions 39 and 44 of 1999 changed the credit classification rules in order to strengthen the loan loss provisioning regime for both performing and foreclosed assets, with the aim of making them comparable to international norms by 2002. In addition, it strengthened the on-site supervision process and initiated supervision on a consolidated level. Moreover, as a result of Law 510 that was passed in August 1999, minimum capital standards were established and early warning indicators were introduced to detect capital problems and allow the adoption of recovery programs or other appropriate measures.

17. **As a result of the crisis, the banking industry shrunk considerably due to the intervention of a number of insolvent banks and the merger of weaker institutions**. As many as 35 entities were intervened for liquidation between 1998 and 2003, and another 20 were voluntarily liquidated by their

shareholders. Liquidation and merger activity during that period contributed to the significant reduction (from 148 to 64) in the number of financial institutions covered by FOGAFIN's deposit insurance mechanism. The overall size of assets of the banking industry also shrunk, reaching 44 percent of GDP in 2002 compared to 57 percent in 1998; this was also reflected in the significant reduction in financial intermediation, with gross loans plummeting from 38 percent to 25 percent of GDP over that period (see Tables on Colombian Banking System in section 10).

18. **Although a systemic financial collapse had been averted, the health of the banking system remained weak at the time of the Program's preparation**. In particular, there was concern that the persistence of adverse economic conditions would not allow banks to repay FOGAFIN, thereby forcing the State to take them over and incur greater fiscal liabilities. There were also significant weaknesses remaining in the housing finance sector where non-performing loans continued to loom large (especially in state-controlled entities and in private banks' mortgage portfolios), while profitability and capital strength of most institutions was relatively weak. In addition, during 2002, the financial system was jolted once again by volatility in the government securities (TES) market, which exposed a weak public debt management process, an unreliable debt valuation mechanism, and an over-exposure to government debt by banks, pension and investment funds. This episode of market illiquidity and vulnerability showed how money market weaknesses could hinder not only the development of the public debt markets but also the stability of the financial system. Banks were forced to re-classify some of the TES holdings from the trading portfolio, which is subject to daily marking-to-market, to the held-to-maturity portfolio in order to reduce volatility in earnings. In response to the TES crisis, the authorities set several key priorities for the improvement of market liquidity and the reduction of financial market risk, which were incorporated into the Program.

19. **The health of the banking system had considerably improved by the time of PFSAL II preparation in 2004**. After a long period of shrinkage, banking system size (assets, loans and deposits to GDP) began to recover during that year, while standard financial performance indicators (see Tables on Colombian Banking System in section 10) of solvency, profitability, efficiency and asset quality significantly improved. This reflected a combination of factors, such as the partial resumption of economic growth, a stable net interest margin in spite of declining interest rates, as well as the recapitalization and exit and/or restructuring of significant non-performing assets that had taken place in previous years. As a result, the financial reforms underpinning PFSAL II placed greater emphasis on consolidating recent achievements and expanding them to include non-bank financial institutions and capital markets.

Assessment of Development Objectives

20. **The objectives of the Program were comprehensive and addressed major areas for improvement**. The two Operations provided a critical mass of support for the Government's medium-term strategic framework for reforms in the financial sector. The goal of upgrading the legal and regulatory framework for banking and capital markets was essential to mitigate existing weaknesses in the financial system. The remaining problems from the 1998-99 crisis still posed a challenge to the sustainable recovery of BECHs, and the existing state-owned banks represented a potentially growing fiscal liability. Both of these areas were identified and addressed successfully by the Program. The objective of strengthening capital and debt markets was particularly important in light of the vulnerabilities in existing risk management practices that were exposed by the mini-TES crisis of 2002.

21. **The Program was also closely linked to the Bank's existing country dialogue**. As explained in the ICR for PFSAL I, the Program was closely linked to the Bank's Country Assistance Strategy or CAS

(see "*Colombia – Country Assistance Strategy*", World Bank Report No. 25129-CO, December 24, 2002). In consolidating the reforms of the financial sector, the CAS had identified the following components: clean up of the 1999 banking crisis, resolving the weaknesses in the housing finance sector, addressing the risks associated with asset-liability mismatches, strengthening of the anti-money laundering regime, downsizing the role of the public sector in the financial sector, expansion of housing finance, reform of the pension system and creation of a deeper, more liquid capital market. These objectives also coincided with the government's agenda for the financial sector. The Program was also preceded by a successful FSAL during 1999-2000 that had helped set the stage for closer collaboration with the Government in financial sector reforms (see "*ICR for Colombia FSAL*", World Bank, December 2002). The measures supported by the FSAL had focused on three key areas: (i) intervention, liquidity and capital support for weak institutions during the financial crisis; (ii) strengthening of capital and solvency standards; and (iii) implementation of early corrective actions by the SB and FOGAFIN to avert an eventual failure of an institution.

22. **The programmatic approach provided much-needed flexibility in conditionality design.** A programmatic approach was adopted because of its flexibility, particularly with respect to the final design of the PFSAL II**.** The first Operation focused on institutional reforms with greater attention paid to the banking system, while the second focused on the implementation of those reforms and the upgrading of the legal framework of the securities market. At the time of Program design, the timing of these reforms and their implementation was not predictable. The components included in the two Operations (see below) were those considered to be realistically identifiable at that time.

23. **Principal risks to the Program were also identified and overcome.** As specified in the Program Document, the principal risks to the Program were: (i) the possibility of adverse external economic shocks; (ii) a low or negative growth scenario during implementation of the Program; (iii) a higher than expected fiscal deficit and its impact on the government debt market; and (iv) a deterioration in internal conflict that would contribute to greater fiscal stress as well as to crippling the reform process. While these factors were considered to weigh negatively on the potential outcome, strong Government commitment to the reforms, plus a positive track record in handling the crisis to-date, served to quell negative sentiment regarding an ambitious financial sector Program. In addition, projected economic growth did pose some concerns since it was barely sufficient to trigger a rebound in the financial system and contribute to a noticeable reduction in poverty levels. Once again, this factor argued in favor of a more conservative approach in terms of Program outputs. The risk area with highest uncertainty was the evolution of the internal security situation and its management by the Government. Thus the level of complexity of the Program and the time-bound outcome expectations needed to be structured with keen sensitivity to the obstacles posed by the ongoing internal conflict.

24. **The design of PFSAL II was also consistent with Program objectives, and built on the accomplishments of the first operation while addressing areas that needed more attention**. In framing the strategy for the second operation, the Bank incorporated the findings of a Stocktaking Report, jointly prepared by the Government and the Bank (see "*The Recovery of Colombia's Financial System and Remaining Vulnerabilities*", World Bank and Colombia's Ministry of Finance, July 2004). PFSAL II focused more attention on the development of capital markets and the implementation of risk management practices in non-bank financial institutions such as the trust and pension industries, while continuing to support important reforms associated with the Program's banking system objectives.

3.2 Revised Objective:

The Program objectives remained unchanged.

3.3 Original Components:

25. **In addition to the maintenance of a sound macroeconomic policy environment, there were five principal components of the Program (see Policy Matrix in Annex 8)**:

I. Bank Regulation and Resolution

- Enactment and implementation of the new Financial System Law (Law 795/2003) to ensure sustainability of the financial system by upgrading the banking regulatory, supervisory and institutional framework;
- Implementation of the new Financial System Law to improve the effectiveness of banking resolution procedures by upgrading the bank resolution and deposit insurance operational framework;
- Privatization and winding down of State-owned banks.

II. Housing Finance

- Strengthening the housing finance sector and expanding the mortgage market by upgrading the regulatory/operational framework of the sector and improving access to credit through the creation of new financial risk management instruments and promoting the availability of longer term funding.

III. Non-bank Financial Institutions

- Strengthening the regulatory framework and financial soundness of the insurance, trust and pension industries by upgrading the regulatory framework for risk management and capital adequacy for non-bank financial institutions.

IV. Capital Markets

- Modernization of the legislative framework for the securities market by upgrading the regulatory framework for the governance, transparency, operations and liquidity of the market.

V. The Government Debt and Money Markets

- Upgrading the policy and operational framework for the government securities market by implementing a public debt issuance strategy to improve the functioning and development of referential rates of the market.

Design of Component I: Bank Regulation and Resolution

26. **The banking regulation and resolution component was centered on reform of the banking system law to strengthen risk-based supervision and to make banking resolution procedures more effective**. PFSAL I was anchored in the passage of the new financial system Law 795 in 2003 and the development of appropriate rules and regulations to enhance management practices, asset quality, earnings performance, and liquidity of financial intermediaries, while introducing new methodologies for measuring and managing credit risk, interest rate risk, and other market risks. With respect to corporate governance, the Law established new accountability standards starting with the independence of the Board of Directors, the prevention of conflicts of interest, and the enhancement of the existing code of conduct. Under the first loan, the anti-money laundering regime was also substantially strengthened through the MoF's Financial Analysis and Intelligence Unit (UIAF). A new problem bank resolution tool involving a progressive carve-out of productive assets from failing banks was developed, with FOGAFIN authorized to provide credit guarantees on the performance of those assets in order to enhance their marketability to other banks and investors. FOGAFIN was also authorized to swap mortgage-backed securities (MBS) for bonds under a specialized facility in order to enhance the liquidity of such instruments.

27. **With regards to bank regulation, PFSAL II focused primarily on the implementation of institutional reforms brought about by the passage of Law 795-2003**. The SB developed a CAMEL-based (Capital/Assets/Management/Earnings/Liquidity) supervisory risk rating model. Basel II-oriented credit risk management practices were instituted in the form of a supervisory framework (*Sistema de Administración de Riesgos de Crédito* or SARC) that promoted better risk governance and allowed internal bank credit risk models to statistically determine expected loan losses based on default probabilities. In addition, the SB implemented a comprehensive value-at-risk methodology to incorporate market risks in the trading book and interest rate risk in the banking book into the determination of regulatory capital. While Colombia's SARC framework was not originally intended to be aligned to Basel II, it is one of the few countries in the region that has pushed the envelope in terms of credit risk measurement and management sophistication. In addition to SARC and in order to ensure the adequacy of human and technical resources to implement this reform, the SB had developed an action plan documenting the budgetary, personnel, and computing resources required, as well as the implied timelines to complete the review and approval process of each bank's credit risk model. This initiative was strongly endorsed by the Bank and was established as a trigger measure for PFSAL II. In addition, the Bank highlighted two areas of reform under PFSAL II that involved the introduction of guidelines for disciplinary rules based on risk considerations, including graduated levels of sanctions for varying breaches of regulatory compliance and the issuance of new norms for the measurement of risks associated with financial groups.

28. **This component also sought to bring the winding down process for *officialized* banks to a close in order to further enhance the role of the private sector in financial intermediation**. The key remaining banks at the time of PFSAL I were *BANCAFE* and *GRANAHORRAR*. In addition, the Government was considering a strategy to consolidate some of the second tier banks in order to reduce the presence of State banking institutions. An immediate goal for the first Operation was to begin the process of privatizing *BANCAFE*, while further consolidation in the State-owned second-tier banking sector was accomplished through the transfer of a portion of the industrial development bank's (*INSTITUTO DE FOMENTO INDUSTRIAL* or *IFI*) assets and liabilities to *BANCOLDEX*, the export bank, and liquidation of the rest. Under PFSAL II and given the failed attempt to auction *BANCAFE* in 2004 (see section on outcomes), the government via FOGAFIN issued an alternative action plan for the eventual sale of *BANCAFE* and *GRANAHORRAR* (which was subsequently privatized on 31 October 2005) and to complete the liquidation of *IFI*.

Design of Component II: Housing Finance

29. **The housing finance component supported reforms to strengthen the mortgage market that had been severely weakened by the crisis in 1998-1999**. Under PFSAL I, foreclosure proceedings were streamlined via the enactment of Law 794-2003. Various hedging and liquidity mechanisms were developed to protect both borrowers and financial institutions from interest rate and inflation risks associated with the indexed mortgage instruments. A FOGAFIN inflation swap scheme was developed to allow borrowers who received UVR-indexed mortgage loans to swap these into fixed-rate peso loans. This supported the banks' issuance of UVR-indexed residential mortgages even when borrowers preferred a fixed rate loan, by allowing the borrowers to swap those mortgages into a fixed rate loan. At the same time, a Central Bank swap facility (*Fondo de Reserva para la Estabilización de la Cartera Hipotecaria* or FRECH), later modified to an options facility, was offered to banks in order to reduce their interest rate mismatch and hedge rising interest rates. This need arose from the fact that most housing loans are indexed to inflation using the UVR index, while banks usually pay a nominal peso interest rate on their time deposits (DTF or Depósitos a Término Fijo). The short duration of these deposits imply that the banks' liabilities are being re-priced more frequently than mortgages that are priced at a fixed spread over the UVR index for the

entire term of the loan; as a result, banks (and especially mortgage banks) are vulnerable to a jump in nominal interest rates that would create an unfavorable interest rate gap between their liabilities and assets. Finally, a separate initiative to allow the Central Bank to accept MBS in a *repo* operation in lieu of government securities was aimed at increasing the liquidity of the secondary mortgage bond market.

30. **The housing finance component in PFSAL II focused on the development of micro-housing credit and on improving the regulations dealing with risk classification of multi-tiered MBS instruments and the regulatory capital requirements of securitization companies**. With respect to micro-housing finance, Law 795-2003 had improved access by banks to this market and to the housing lease market. In PFSAL II, the government obtained a voluntary agreement from commercial banks to allocate a small portion of their portfolio funding towards this sector. Alternatively, the banks could participate in the purchase of bonds issued by the second-tier municipal financing bank *Financiera de Desarrollo Territorial* (FINDETER), which would subsequently on-lend those funds for microhousing finance purposes. To complement the FINDETER program and increase private bank participation, the government's National Guarantee Fund (FNG) implemented a credit insurance program for loans given to lower income communities. With the evolution of the mortgage securitization market, the SB progressed in developing a sound regulatory framework for these instruments while preventing (but not completely eliminating) regulatory arbitrage in their usage. In this regard, an important change to the capital adequacy framework was the recognition of the existence of different levels of credit risk in different tranches of a securitization, and the application of Basel II-like capital adequacy rules for each tranche based on its respective credit rating. The *Superintendencia de Valores* (SV) also introduced a risk-based capital regulation to cover the credit and market risks incurred by securitization companies.

Design of Component III: Non-bank Financial Institutions

31. **In order the support the diversification of their activities, the non-bank financial institutions component focused on strengthening transparency and risk management**. PFSAL I dealt with the insurance industry and the implementation of a system for analysis and reporting of insurance risks and linking these to solvency margins and technical reserve requirements by line of business. PFSAL II addressed the pension and trust industries, emphasizing disclosure of market risks of all types of investment portfolios and reform of rules concerning pension fund investments in foreign securities and in related parties.

Design of Component IV: Capital Markets

32. **The draft Securities Law formed the cornerstone of the capital markets component, and its preparation and submission to Congress was part of the agenda for PFSAL II**. Under PFSAL I, the SB and SV issued uniform criteria for the valuation of private sector fixed income securities held by banks, non-bank financial institutions and securities firms, and agreed to carry out joint supervision and surveillance of securities brokers and dealers. Under PFSAL II, a draft Securities Law was presented to Congress to enhance the legal framework of the securities markets by establishing norms for corporate governance, defining SV supervisory powers, custody, clearance and settlement regulations, regulation of intermediaries, qualifying professional criteria for market participants/brokers, shareholder protection, harmonization of mutual funds regulations, and new standards for the valuation of securities. The SV also issued new norms for mutual funds' public information disclosure requirements, while new reporting requirements by the SB and SV incorporating both credit risk and market risk ratings of investment funds were implemented. Finally, new regulations were also issued for the daily mark-to-market valuation of mutual funds' portfolios.

Design of Component V: The Government Debt and Money Markets

33. **This component supported government debt and money market development, and fostered better risk management practices by market participants**. Under PFSAL I, the MoF strengthened the obligations of primary dealers in their role as market makers, while the SV regulated the valuation of domestic treasury securities. Under PFSAL II, a debt issuance strategy was established with the support of a high-level public debt policy committee, while additional steps were taken to improve liquidity and market price formation in the short end of the public zero risk yield curve, to be achieved via a new issuance program that relied on weekly 90-day TES auctions of progressively greater size.

Assessment of Program Components

34. **The bank regulation and resolution component was consistent with and aligned well to the Program objectives**. Passage of a new financial system law (Law 795 in 2003) and its implementation sought to strengthen bank regulation and enhance the supervisory powers of SB. While there were no imminent threats of bank failures, the development of an additional bank resolution instrument was essential for the long-term sustainability of the banking system and to prevent future build up of fiscal liabilities. The winding down and eventual sale of the three large state-owned banks was expected to reduce future government liabilities while contributing to greater efficiency of financial intermediation. However, it is worth noting that one source of latent risk in the banking system, i.e. the absence of fully consolidated supervisory framework over the financial conglomerates that dominate Colombia's financial system, was not fully addressed by the reforms in the bank regulation and resolution component. This was a reflection of Colombia's financial system condition priorities and political economy considerations at the time, although some useful steps have been made in that direction (see section on Outcomes).

35. **The design of the housing finance component was more effective at addressing mortgage market stability issues than constraints to access to housing credit**. Mortgage securitizations, streamlined foreclosure-related judicial proceedings and the inflation and interest rate hedges sought to enable banks (particularly BECHs) to improve the quality of their loan portfolio, reduce their interest rate risk and increase profitability. However, while the leasing and micro-housing finance sub-component was a step in the right direction, the goal of offering greater access to financial services by the underserved sectors might have benefited from more support directly targeted at alleviating the limited availability of resources for all types of micro-finance activities, particularly when comparing Colombia to other countries in the region. Another reason for the inability to – in retrospect – sufficiently address housing credit constraints also stemmed from political economy considerations (i.e. the ceiling on mortgage rates that was set by the Constitutional Court) and limited risk tolerance of both mortgage lenders and debtors brought about by the still fresh memories of the financial crisis in 1998-1999.

36. **The non-bank financial institutions component likewise focused more on financial stability issues than in directly promoting financial deepening**. The design of the insurance sub-component addressed the need to establish solvency margins and technical reserve requirements, but the capacity of supervisors or the industry itself to apply these new risk-sensitive rules was not – in retrospect – sufficiently considered. With respect to the trust and pension sub-component, the implementation of Value-at-Risk (VAR) methodologies and of a consistent mandatory reporting for market risks in investment portfolios was a positive and non-trivial task: as shown in the box below, the diversity in composition and oversight responsibility of investment funds in Colombia underscores the complexity of efficiently applying these norms.

Colombia: Investment Funds Industry

I. Mandatory Investment Funds
  1. Social Security Fund
  2. Individual Capitalization Funds (AFPs) (SB)

II. Non-Mandatory Investment Funds
  A. Trust Funds (SB)
    - Voluntary Pension Funds
    - Ordinary Funds
    - Special Purpose Funds
  B. Stock Funds (SV)
  C. Pension Fund Companies (SV)
  D. Mutual Funds (special purpose funds offered by employers)

Note: SB and SV in parentheses denotes supervisory agency.

37. **The capital markets component of the program was well focused on long-term institutional development**. The key institutional component was the enhancement of the legal framework for the securities market. A more short-term goal was to achieve better coordination between SB and SV in their supervisory activities in areas of overlap, particularly since each supervisory agency had oversight responsibilities over different parts of the investment funds industry. Following the passage of the new Securities Law, which was supported by PFSAL II, the Colombian government made the decision to merge the two supervisory agencies, an initiative that had not been contemplated at the time of Program design and which is expected to enhance – if adequately implemented – the effectiveness of Program outcomes.

38. **The government debt market component was developed partly as a result of the TES crisis in 2002, which pointed to deficiencies in market pricing and in the government's debt issuance strategy**. The principal output was the development of a debt issuance strategy, the creation of a new MoF – Central Bank debt committee to review and advise the Minister of Finance on debt strategies, and the development of a liquid short-term TES market that would facilitate the establishment of a reliable benchmark yield curve for government securities. This component made an important contribution to the development of the domestic money and government debt markets which had previously lacked a government risk-free reference rate on the short end of the yield curve.

39. **The scope of the components and their expected outcomes was somewhat ambitious for a Program consisting of only two loan operations**. While relevant, the strengthening and diversification of non-bank financial intermediaries and improving access to housing credit for underserved segments of the population were not the primary objectives of the Program. Since the banking system was the dominant component of the financial system, supporting sound and sustainable growth of banks, especially after the 1998-1999 bank crisis, was a greater priority. The support provided by the Program to the insurance, pension, trust and housing microcredit industries represents arguably a more complex and longer-term goal that could potentially have been better addressed via a third programmatic loan that focused on the development of non-bank financial intermediation and access to credit.

3.4 Revised Components:

40. The program components remained unchanged.

3.5 Quality at Entry:

Quality at entry of the Program

41. **Overall Program design was highly relevant to the government's development objectives and the need to support sustainable economic growth through a more efficient financial system, as reflected in the Bank's Colombia CAS**. Preparation of the Program benefited from participation by competent and experienced teams from the Bank and the Colombian Government. The success of an earlier FSAL was instrumental in establishing a productive dialogue between the two teams. The Program also benefited from extensive Bank-led economic and sector work during that period, particularly in the areas of banking system performance (stocktaking report and assistance on consolidated supervision issues) and debt market development (see "*Reform Roadmap: Strategic Choices in Developing Colombia's Debt Markets*", World Bank, February 2003), as well as close collaboration (including supervisory training) in housing finance issues. The analysis of program risks was comprehensive and the assumptions regarding the impact of macro-economic factors were realistic.

Quality at entry of PFSAL II

42. **Quality at entry of PFSAL II is judged to be Satisfactory**. The Program objectives were in line with the government's development agenda and, an issue particularly important with middle-income countries, accompanied a reform process initiated by the MoF itself. The design of the PFSAL II was complementary to the outputs achieved during the first Operation and partly took into consideration the recommendations made in the stocktaking report. The continuity of the team members on both sides facilitated the negotiations and contributed to the high quality of design of the second Operation. However, the broad range of financial sector reforms that was covered by the five components likely inhibited their clear prioritization and potentially overstretched scarce team resources.

4. Achievement of Objective and Outputs

4.1 Outcome/achievement of objective:

Outcome of the overall Program

43. **The overall outcome of the Program has been favorable, although some of the specific objectives are medium-term goals for which the critical mass of outcomes has not yet been fully realized**. This section first reviews the principal outcomes to-date in the sectors supported by the Program (banking, housing finance, insurance, pensions/trusts, capital markets and government debt markets) using specific relevant indicators that were identified at the time of loan appraisal (see Annex 1 for a summary), and then evaluates the outcome of PFSAL II in terms of its attribution to these outcomes.

Macroeconomic Environment

44. **Macroeconomic performance has improved over the Program's horizon**. Supported by a pick-up in global economic activity, real GDP grew by 4.0 percent per annum in 2003 and 2004, which was higher than envisioned at the start of the Program (see table on Selected Economic Indicators in section 10). Inflation dropped to its lowest level in a generation, reaching 5.5 percent in 2004 from 7.0 percent in 2002. Domestic interest rates declined to single-digit levels compared to the crisis period, while strong capital inflows led to an appreciation of the peso in 2002-2004 and domestic investment rebounded. The

government continued to make progress on fiscal adjustment, with the combined public sector deficit narrowing to 1.3 percent of GDP in 2004, down from 3.7 percent of GDP in 2002 – see "*Country Assistance Strategy Progress Report for Colombia*" (World Bank, September 2005) and "*Colombia – 2005 Article IV Consultation*" (IMF, May 2005) for more details.

Banking System

45. **Banking system performance continued to improve during 2003-2004 in terms of solvency, profitability and asset quality, a clear indication that the recovery from the 1998-1999 crisis is on a sustainable path**. As shown in the table below, Return on Average Equity (ROAE) reached 23 percent in 2004, compared to a loss of 20.7 percent in 2000 at the height of the crisis (see Tables on Colombian Banking System in section 10). The stability of the capital adequacy ratio at 13-14 percent of assets during the 2000-2004 period – in spite of the introduction of progressively stricter market risk capital requirements – is a tribute to the agility of the government's response to the crisis through the innovative capitalization program offered to public and private sector banks as well as the debtors' relief programs. Net interest income has improved modestly, mostly as a result of lower funding costs combined with more "sticky" pricing on the asset side. After a long period of shrinkage, banking system size and financial intermediation have started to recover, as shown by the modest increase in the loan to GDP ratio to 24.5 percent in 2004. At the same time, the proportion of past due loans has been steadily declining down to 3.3 percent of total loans in 2004.

Table 1: Banking System Indicators

	2000	2001	2002	2003	2004
(figures in percent)					
ROAA	-2.3	0.1	1.1	1.9	2.7
ROAE	-20.7	1.1	9.6	17.1	23.0
Capital adequacy ratio	13.2	13.3	12.5	13.1	13.8
Net Interest / assets	3.5	3.1	3.4	3.9	4.2
Gross Loans / GDP	27.0	25.3	24.6	23.1	24.5
Efficiency ratio	80.0	74.1	71.1	61.5	54.1
Past due / total loans	11.0	9.7	8.7	6.8	3.3

Source: SB

46. **According to the stocktaking report, the recovery in performance of the banking system can be attributed to four main factors**. These are: (i) the resumption of economic growth; (ii) a stable net interest margin in spite of declining interest rates; (iii) the exit and/or restructuring of significant non-performing assets in previous years; and (iv) the government's recapitalization program for both public and private sector banks. At the same time, the banks' increased focus on risk management has contributed to the sound growth of the banking system, which has also been supported by a more proactive banking supervision relying on more sophisticated monitoring tools.

47. **With the introduction of SARC for credit risk management and a VAR framework for market risk capital requirements, Colombia is at the forefront in the adoption of risk management standards in the region**. Nevertheless, implementation of these new risk management techniques needs to proceed with caution as the Bank recommended during the design of the Program. The development of

internal credit risk models is dependent on a large amount of accurate historical credit information, while the quantitative output of these models needs to be complemented with a more subjective evaluation of the banks' risk management capacities that is not easily captured in a quantitative framework. On the other hand, the new credit risk models can provide bank management a more accurate measure of the potential magnitude of portfolio problems and contribute to better diversification of the loan portfolio.

48. **FOGAFIN's track record in managing weak banks, in recovering bad loans, and in downsizing and eventually selling off State-owned banks, has produced tangible benefits in terms of reducing the magnitude of fiscal liabilities**. As shown in the table below, and based on the various programs administered by FOGAFIN explained in the aforementioned section, the latest estimate of the fiscal burden from the banking system bailout currently stands at about 2.6 percent of GDP, down from the original contribution of 6.3 percent (the figure of 10 percent that was used in the earlier section was in relation to GDP in 1999, while this figure relates to GDP in 2004). An important component of the reduced liability resides with the successful management of state-owned and intervened banks, such as the improvement in financial performance of *BANCAFE* and *GRANAHORRAR* (the latter was subsequently privatized - see below), and the winding down of *IFI*'s first-tier operations and transfer of its second-tier operations to *BANCOLDEX*. This is reflected below in the Support and Recoveries figures, as well as in the Residual Assets at Book Value figure. The biggest cost component of the bailout of the banking system crisis has been the public sector banks, while the highest payback involves the loans to private sector banks that are being repaid as originally scheduled.

Table 2: Cost to the Government of the Banking System Crisis 1998 - 2004

(billions of pesos)	Total Support	Recoveries	Residual Assets at Book Value	Net Costs
Public sector banks	5,954	965	1,036	3,953
Intervened banks	2,884	976	1,037	871
Cooperatives	1,968	1,088	370	510
Debtor relief programs	3,292	572	1,686	1,034
Private sector banks	1,637	420	1,147	70
Other	440	319	20	101
Total	16,175	4,340	5,296	6,539
(percent of 2004 GDP)	6.3%	1.7%	2.1%	2.6%

Source: FOGAFIN

49. **In spite of the generally optimistic picture on the banking system, the stocktaking report identified certain outstanding vulnerabilities that should be addressed going forward**. The most important of these are: (i) improvement of financial system surveillance and coordination among relevant agencies; (ii) focus on specific risks (interest rate mismatch and credit quality) of mortgage banks; (iii) adoption of consolidated supervision for financial conglomerates; and (iv) diversification of the exposure of the financial system away from public sector debt. The last issue is particularly relevant, since it can potentially lead to higher income volatility, can crowd out private sector lending and can create a false sense of security (zero risk weights for capital adequacy purposes). Public sector exposure (primarily through TES investments) of the banking system rose from 11.2 percent in 1998 to 25.8 percent in 2003.

50. **Some of the recommendations of the stocktaking report were addressed in PFSAL II**. In particular, the second Operation included a draft Circular on capital regulations for financial conglomerates, assistance in modifying the FRECH swap hedge into an option instrument (see below), the expansion of good practice risk management and other prudential regulations to non-bank financial intermediaries, and continued support to the efforts by SB to implement SARC. At the same time, the recent pickup in economic growth and private sector lending has halted the increase in public sector exposure of bank balance sheets and, in the absence of an economic shock, this is expected to continue in the foreseeable future.

Housing Finance

51. **The health of the housing finance portfolio has improved noticeably since the 1998-99 crisis, but origination of new mortgages remains limited**. In terms of size, total banking system mortgage financing fell from 13,219 billion pesos in 1997 to 7,088 billion in 2004, reflecting the exit and intervention of the old housing savings and loans banks (CAVs), the write-downs of the loan portfolio, and more recently the securitization of a sizeable portion of outstanding mortgages in 2003-04 that includes the only Latin American issuance to-date of MBS that are backed by a portfolio of non-performing mortgages. On a positive note, the volume of banking system financing started to slowly expand again during the first half of 2005. As shown in Table 3, total housing finance by the financial system has not fallen as much when adjusted for the sizeable increase in securitization of mortgages, which in 2004 accounted for 26.0 percent of total financial system credit to housing. In addition, past-due mortgages have decreased from 24.6 percent of total mortgages in 2002 to 9.8 percent in 2004, although part of this drop can be attributed to the securitization of non-performing mortgages. While the biggest drop in the average price of new homes occurred during 1995-1997, the average price of new homes has stabilized in recent years, which is welcome for long-term loan-to-value ratios.

52. **With lower risks in mortgage financing and a more stable macroeconomic environment, interest rates on VIS (*Vivienda de Interés Social* or Social Priority Housing) and non-VIS loans have started to decline**. During the first half of 2005, the UVR spread on non-VIS loans had dipped to 11.46 percent and for VIS loans to 10.58 percent. Another important development has been the rise in fixed-rate peso mortgage financing. Based on new mortgage loan disbursements, fixed-rate peso financing has risen from 1.4 percent of total disbursements during the second half of 2002, to 16.9 percent during the first half of 2005. This positive development can also be linked to the success of the government's debt management strategy, through the market's acceptance of the 10 year government bond that acts as a key reference rate in the pricing of fixed-rate peso mortgages.

Table 3: Selected Indicators: Housing Finance

	2000	2001	2002	2003	2004
Banking System Credit to Housing	12,853.2	12,404.7	10,914.9	9,626.3	7,088.0
Past Due mortgages as % of total	19.7%	21.4%	24.6%	23.6%	9.8%
Financial System Credit to Housing				14,908.5	14,009.0
non-VIS loans	NA	NA	NA	10,118.0	9,237.8
VIS loans	NA	NA	NA	4,790.6	4,771.1
Securitized Mortgage Loans				1,872.6	3,647.9
non-VIS tranches	NA	NA	NA	1,302.0	2,628.5
VIS tranches	NA	NA	NA	570.6	1,019.4
Interest rate spreads on UVR loans:					
non-VIS loans	NA	NA	13.55	13.45	12.34
VIS loans	NA	NA	11.00	10.95	10.71
Fixed Rate Peso rates:					
non-VIS loans	NA	NA	16.1	17.5	19.40
VIS loans	NA	NA	13.3	16.1	16.09
Average Price of new homes (index)	100.5	101.1	100.9	101.4	102.0

Source: Titularizadora Colombiana, Ministerio de Ambiente, Vivienda y Desarrollo Territorial
Note: Financial system includes banking system plus cooperatives, special funds, and other special entities.

53. **Housing banks (BECHs) have begun to diversify their assets in order to become full-fledged commercial banks**. The shift in structure of this market segment is explained primarily by the diversification lesson they learned from the financial crisis, and by the numerous mergers between commercial banks and mortgage banks – supported by the application of new regulatory norms – that have resulted in a more balanced consolidated loan portfolio. The progressively stricter market risk capital adequacy requirements have also contributed to the BECHs' diversification strategy, by penalizing their existing interest rate mismatch exposures (UVR inflation-adjusted rates on mortgage loans and DTF peso-denominated deposit rates) with higher capital requirements. In response, BECHs are slowly diversifying away from mortgages into commercial and consumer lending, where the interest rate denomination (DTF) is the same as for deposits. While these new risk parameters might be discouraging the underwriting of some mortgage loans, the development of MBS securities now offers an opportunity for banks to earn a commission on mortgage underwriting while subsequently transferring the risk to investors via securitization; however, the sustainability of the securitization market hinges on a critical mass of new mortgage business being generated going forward. This has not been the case as yet in spite of a more diversified banking system and better risk management tools, because other housing finance constraints might be binding (e.g. interest rate ceilings established by the Constitutional Court as a means to protect low income borrowers, and the lingering memory from the crisis). The increasing use of fixed-rate peso

mortgage financing should also help to reduce the pricing mismatch since both asset and liabilities will be priced in pesos. As BECHs achieve a more diversified loan and investment portfolio, demand for the FRECH interest rate option hedge facility (see below) should diminish.

54. **One of the more difficult aspects of housing finance has been reaching the underserved population**. While VIS financing has been stable, micro-housing financing has been slow to respond to incentives mechanisms. According to the Ministry of Housing, there are still a number of challenges facing the low-income population in accessing financing. From the lenders' perspectives these include: (i) interest rate ceiling; (ii) difficulty in confirming earning capacity, particularly for those in the informal sector; and (iii) higher underwriting costs. From the borrowers' perspective, the limiting factors include: (i) lack of previous banking relationships; (ii) insufficient information on their financing options; (iii) inability to demonstrate earnings capacity since official earnings usually fall below the threshold to qualify for a mortgage; and (iv) reluctance to approach a bank in view of the experience with the banking system crisis when the interest rate indexation formula had been changed to the borrowers' disadvantage.

Insurance

55. **The insurance industry shows only a marginally improving trend in terms of capitalization and level of activity**. As shown in the table below, solvency margins have increased in both the general and the life insurance segments of the market, although it is questionable whether this can be attributed to (only partially implemented) reforms that were supported under this Program. Insurance premiums as a percent of GDP have increased marginally and remain at relatively low levels. The higher premium revenues for general insurance reflect the industry trend with the post-9/11 rise in premiums in the face of greater general risk. In the case of life insurance, the modest rise in the level of activity is accounted for by growth in economic activity particularly the decline in the unemployment rate which has contributed to an increase in the number of insured. Nevertheless, the low level of insurance premiums relative to the size of the economy points to the existence of a large underserved population. As the private capitalization schemes continue to grow, the insurance industry will play an increasing role in the sustainability of retirees' benefits through annuities and other insurance services.

Table 4: Insurance Industry Indicators

(figures in percent)	2000	2001	2002	2003	2004
Solvency / capitalization					
General insurance	41.3	52.8	58.8	60.2	58.9
Life insurance	38.8	39.0	41.6	44.5	45.2
Insurance premiums / GDP					
General insurance	1.3	1.5	1.7	1.6	1.6
Life insurance	0.9	0.9	1.0	1.0	1.0
Source: SB					

Pension Funds and Trusts

56. **The fund and trust business in Colombia continues to grow steadily, with the AFPs representing the principal players**. The size of the total portfolio of funds has risen from 9.6 percent of

GDP in 2001 to 15.3 percent in June 2005. The strongest growth has been in the individual capitalization funds which are part of the mandatory pension fund system, while the voluntary capitalization funds have exhibited modest growth. Since the reform of the pension system in December 1993, which introduced the individual defined-contribution capitalization accounts, the growth in pension fund assets managed by the AFPs has been gathering momentum. Pension fund affiliates are required to contribute to their individual retirement accounts and in 2003 their total contribution averaged 13.5 percent of wages, of which 10 percent was the amount invested in their individual accounts. It should be noted that the growth in this business cannot be attributed to the Program itself, which supported the longer-term development of pension/trust funds by emphasizing the need for improved disclosure so that affiliates and individual investors could better understand the value of their investments and the associated risks of the pension fund portfolio. The development of the 'Fact Sheets' by investment funds has enhanced the availability of information to individual investors, and it is expected that the new prudential regulations supported by PFSAL II will further encourage the growth of this market.

Table 5: Pension/Trust Fund Indicators

(% of GDP)	2001	2002	2003	2004	June 2005
AFPs					
Individual Capitalization Funds	6.0	7.7	8.8	10.3	10.8
Voluntary Capitalization Funds	1.0	1.2	1.4	1.4	1.6
Trust Funds					
Voluntary	NA	0.2	0.3	0.3	0.3
Ordinary	1.9	1.7	1.7	1.8	1.8
Special Purpose Funds	0.7	0.6	0.8	0.8	0.8
Total	9.6	11.4	13.0	14.6	15.3
Avg. Rate of Return on Selected Funds					
Individual Capitalization Funds	9.97	18.22	17.08	17.39	17.19
Ordinary	9.30	7.38	7.52	6.98	7.81

Source: SB

Capital Markets

57. **The outcome in capital markets has been mixed to date**. Market capitalization has been growing noticeably, as shown in the table below, from 11.5 percent of GDP in 2000 to 25.1 percent in 2004. The strongest performance was in 2004; nevertheless, the growth in market capitalization is attributed mostly to higher share prices helped by the improved outlook for the economy. New market offerings have been disappointing, with equities falling from 11 new issues in 2001 to only 2 in 2004, although this has been partially offset by the issuance of new private sector debt. Although secondary market trading has been dominated by TES reflecting the success of the government's new public debt auction strategy aimed at increasing market liquidity, the relatively high level of domestic public debt has contributed to the partial crowding out of domestic private sector issuance. The new Securities Law, which was recently approved, will likely not have a measurable impact on market activity in the short run, although it is expected to effectively reduce some of the existing barriers to market entry over the medium-term. In addition, other

reforms supported in this Program (e.g. development of mortgage securitization and of a uniform prudential framework for collective investment schemes) are also expected to make a positive contribution to deepening domestic capital markets over time.

Table 6: Capital Market Indicators

(mill US$)	2000	2001	2002	2003	2004
Market Capitalization	9,648.7	10,730.0	9,601.7	14,122.1	24,587.5
% of GDP	11.5%	13.1%	11.8%	17.7%	25.1%
Secondary market trading	27,665.1	32,710.0	111,646.0	134,207.0	233,054.0
of which: government securities	19,946.6	24,160.9	98,259.0	113,985.0	200,438.0
New Issues:					
Equities					
number		11	10	4	2
value		343.5	306.6	192.2	0.6
Private sector bonds					
number		10	13	7	9
value		430.4	831.1	307.1	1,264.4
Other					
number		15	19	18	13
value		2,187.20	1,860.36	1,627.56	1,735.71

Source: SV

Government Debt Market

58. **The domestic government debt market has benefited greatly in recent years from an improved fiscal policy, a more favorable macroeconomic environment, and better institutional arrangements and strategy for public debt**. The public sector debt to GDP ratio has declined from 63.6 percent of GDP in December 2002 to 59.1 percent in September 2004, although part of the improvement is attributed to a decline in the external debt ratio due to the appreciation in the value of the peso relative to the US dollar. At the same time, the government debt strategy of developing a domestic zero risk yield curve supported by the Program has enhanced liquidity in the secondary market. As shown in the table below, the government securities (TES) yield curve has shifted down and become flatter in the past two years. The decline in the 2 and 5 year bonds has been more consistent than for the 10 year bond reflecting the relatively lower liquidity of the 10 year bond due to its more recent introduction. A more accurate yield curve will contribute to less pricing volatility of government securities and hence better valuation of investment portfolios. With a more reliable government yield curve, market participants will be able to better price non-government securities off the risk-free reference rate. Such a development is already starting to take place with the recent introduction of a 10-year fixed peso rate mortgage whose price is based on the 10-year TES bond reference rate.

Table 7: Government Securities Yield Curve (TES)

(%)	90 days	1 year	2 years	5 years	10 years
2003					
June	7.83	9.85	11.65	14.10	15.24
December	9.06	10.34	11.63	13.81	15.18
2004					
June	7.43	9.32	11.14	13.97	15.49
December	7.32	8.29	9.40	11.76	13.75
2005					
June	5.96	6.73	7.67	9.93	12.41

Note: end of month rates.
Source: Banco de la Republica

Assessment of Outcome of the Current Operation (PFSAL II)

59. **Based on the Program outcomes to-date and their attribution to the current Operation, the outcome of PFSAL II is considered Satisfactory**. Achievement of the Program's principal objectives was enhanced by PFSAL II, particularly with regards to strengthening the government's capacity to mitigate weaknesses in the banking system and completing the clean up of the banking crisis. The bank regulation and resolution and government debt market components of PFSAL II were contributing factors to the achievement of these objectives, and have also supported the rebound in economic activity that has taken place. By contrast, experience in developing housing finance, non-bank financial institutions and capital markets was more limited in reaching their expected outcomes in the short term, although early expectations should perhaps have been more tempered in these areas given the presence of other binding constraints and the longer-term nature of such development.

60. **The successful implementation of the banking regulation and resolution component contributed to improved performance of the banking system, enhanced supervisory practices, and a reduction in fiscal liabilities from the banking crisis**. New norms issued by the SB in the application of Law 795 have reinforced surveillance capacity with stronger enforcement capabilities and greater focus on the risks from financial groups. The mechanisms for quick bank resolution are in place, even through no interventions have been necessary during the period of the Program. Although the winding down of state-owned banks is not yet complete, significant steps have also been taken in that direction (the most recent being the sale of *GRANAHORRAR* to Spanish bank *BBVA* on 31 October 2005) and the sale of *GRANBANCO* (the legal entity that has substituted *BANCAFE* – see next section) could be completed by 2007. As shown in the previous section, the net cost of the banking crisis to the government is currently estimated at 2.6 percent of GDP, which is down from an earlier estimate of 4.5 percent and significantly below the level of the initial contribution due to asset and cash recoveries.

61. **Experience to-date has been more mixed with regards to outcomes attributable to PFSAL II that are related to the housing finance, non-bank financial institutions and capital markets components, although development in these areas is a longer-term process**. Progress on housing finance has been helped by growth in securitization of mortgages, which currently represents about 26.0 percent of

banking system credit to housing. On the other hand, micro-housing financing has moved slowly; while banks have mobilized more resources to micro-financing based on their commitments with the government, other intermediaries such as financial cooperatives (CCFs) and other social funds have not met expectations, although some improvement has been noted in 2005. Strengthening and diversifying the risks of other non-bank financial institutions such as insurance companies and pension funds is a longer term process that has not yet produced tangible results. Capital markets are still dominated by the government securities and private sector issuance is limited, although the new Securities Law should contribute to increased activity in the medium term. On the other hand, progress in the development of the government's debt market strategy has improved liquidity in the money market and should act as a catalyst to the issuance of private sector securities that rely on a risk-free rate as the basis for valuation.

4.2 Outputs by components:

Component I: Bank Regulation and Resolution

Banking regulations

62. **PFSAL I:** The new Financial System Law (795/2003) covers a broad spectrum of reforms in financial legislation, ranging from corporate governance norms to bank restructuring procedures. Some of the key reforms addressed by this law include corporate governance, enhanced reporting requirements for financial intermediaries, increased enforcement powers for the SB, introduction of new types of financial instruments, institutional strengthening of the SB, greater protection of depositors, a new procedure for asset-liability transfers and carve-outs from failing banks, and more extensive monitoring of money laundering activities by the MoF's AML unit.

63. The law was complemented by a series of prudential measures. The SB has developed methods for evaluating financial intermediaries based on their risk profiles. An expanded supervisory rating system has been implemented and is being used to assess deposit insurance fees based on the risk of the institution. New banking regulations have aligned risk management practices much closer to Basel II standards. The introduction of the SARC (Credit Risk Management System) methodology requires banks to either develop internal models for quantification of credit risks and to use them for loan loss provisioning, or to utilize the SB's reference models. The transition period to fully implement the new methodology extends until 2009, which allows time for the intermediaries to compile the relevant data bases and to test the models. The SB has introduced sophisticated VAR-based market risk capital requirements and has issued market valuation regulations jointly with the SV.

64. **PFSAL II:** The stocktaking report candidly analyzed strengths and weaknesses in the banking system, and provided recommendations for follow-up actions during the second Operation. New norms have been developed to enhance the regulatory environment, such as draft rules for capital exposure arising from financial groups, although their implementation awaits a new decree that would define the SB's authority to receive information regarding the consolidation of financial groups. However, as identified both in earlier Bank policy analysis (see "*Colombia – Supervision of Financial Conglomerates – Summary Draft Distance Report*", World Bank, June 2004) and in the September 2004 Financial Sector Assessment Program (FSAP), important revisions in the consolidated supervision framework are still pending, such as legal modifications to the Commercial Code covering the definition of a financial conglomerate (i.e. presumption of subordination or 'dominant influence') and the scope and conduct of consolidated supervision itself. This is important given the dominance and complexity in structure of domestic financial conglomerates that are controlled by economic groups with significant commercial interests. In addition, a conflict of interest policy by the SB is being developed to include a list of conflict situations that would serve as the standard for all financial institutions. Finally, new guidelines have been

drafted for the application of disciplinary actions that should contribute to a more uniform application of disciplinary standards, while an appeals unit was created within the legal department of the SB in order to provide a more impartial assessment of disciplinary actions that are under appeal.

Bank resolution process

65. **PFSAL I:** The new banking law defined more precisely the SB's powers and authority regarding bank resolution procedures. Under the new law, the intervention of a bank by the SB triggers an immediate carve-out of assets and liabilities in order to minimize the potential losses to the deposit guarantee agency. The process, whereby the deposit insurance agency (FOGAFIN) carves out the good assets to be placed in a trust under a securitized instrument that in turn backs the corresponding deposit liabilities of the intervened bank, has been applied successfully in other countries and facilitates the prompt transfer of assets to new institutional buyers. FOGAFIN has also been granted the authority to guarantee the assets of the trust using the resources available under the deposit guarantee fund. While no banks have been intervened since the adoption of this new mechanism, FOGAFIN has developed appropriate policies and procedures to ensure effective implementation.

66. **PFSAL II:** The MOF and SB have issued regulatory norms addressing the reform of bank resolution procedures using the asset and liability care-out modality. The procedures provide the SB with the tools to determine the optimal level of asset/liability transfers as a preferred standard procedure, without the need to seek prior authorization from client depositors. This is facilitated through the authority to use asset securitizations to enable a more effective transfer of loan portfolios. The new regulations for implementing this also specify a limit of complementary deposit insurance funds that may be used for non-matched deposits under this transaction – the limit to be used being whatever the deposit insurance fund would have had to pay if all insured deposits of the failed bank had to be redeemed.

Winding down of State-owned banks

67. **PFSAL I:** The winding down of State-owned banks under the management of FOGAFIN was expected to reduce the role of the State in financial intermediation and, from the proceeds of their sale or through the recovery of bank assets, reduce the government's liabilities arising from the 1998-1999 banking crisis. The main institutions slated for sale or restructuring were *BANCAFE*, *GRANAHORRAR* and *IFI*. During the first Operation, the FOGAFIN-owned asset management company (CISA) was authorized to accelerate asset disposition through direct sales and other means such as securitization. From 2000 through the first quarter of 2005, CISA had acquired 4.41 trillion pesos in problem assets and had recovered 1.853 trillion, which represents about half of all recoveries for public sector and intervened banks and cooperatives (see Table 2). *IFI*, the insolvent industrial development bank, was wound down, with its viable assets transferred to *BANCOLDEX*, the export financing agency. The privatization process for *BANCAFE* was initiated with the strategy to find a partner that would purchase 51 percent ownership of the bank. The privatization of *GRANAHORRAR* moved at a slower pace due to several operating issues (e.g. heavy concentration in mortgage sector) that were considered to be an obstacle to its successful sale.

68. **PFSAL II:** Progress was achieved in the sale and liquidation of the state-owned banks, although the timing has been expanded due to unfavorable market conditions. *IFI* was liquidated as planned. On the other hand, two attempts to sell *BANCAFE* through open public offers failed to produce any bids; it was determined that a key deterrent was the labor liabilities and pensions of protected state workers in the bank. FOGAFIN then considered a new strategic plan that appears potentially promising. Through innovative financial engineering involving a restructuring of both *GRANAHORRAR* and *BANCAFE* utilizing the newly

developed “carve-out” technique of bank resolution, FOGAFIN created a new entity called *GRANBANCO* that is comprised of the good assets of *BANCAFE* with additional “excess” capital provided by *GRANAHORRAR* and by CISA from its own asset recoveries. All assets and liabilities of *BANCAFE* except its pension liabilities were transferred to *GRANBANCO*. Following the creation of *GRANBANCO*, FOGAFIN has managed to sell *GRANAHORRAR* to the private sector in an auction on 31 October 2005. The process of operational strengthening of *GRANBANCO* will continue with a possible return to the market for sale by 2007.

Component II: Housing Finance

69. **PFSAL I:** The first Operation supported measures seeking to: (i) streamline the judicial proceedings associated with the foreclosure of mortgaged properties (Law 794/2003); (ii) protect existing mortgage borrowers from unexpected increases in inflation; (iii) allow financial institutions to hedge their interest rate mismatch (FRECH swap hedge) and enhance the liquidity of their mortgage-backed security holdings by swapping those securities for government securities at the Central Bank (FRECH liquidity fund); and (iv) channel more financing to the lower income bracket of the population by expanding micro housing credit and introducing micro-housing leasing through the banking system.

70. Demand for the FOGAFIN-administered inflation hedge by borrowers was below target, in part because declining inflation lowered its perceived importance and also because consumers found the mechanism complex. The Central Bank-run FRECH hedge swap program was not utilized by banks due to its complex design and the relatively low inflation and peso interest rates that may have discouraged banks from incurring the costs associated with this hedging instrument. This is because, in order to protect against upswings in interest rates, participants in the FRECH swap would need to continuously contribute funds reflecting the difference between the current low interest rates and the trigger rate beyond which participants were protected. However, in a low interest rate environment, banks would incur cash outflows and would only benefit once rates rose above the trigger; a protracted period of low rates was therefore making the mechanism less desirable and unpopular. Due to the lack of demand, the swap hedge facility was subsequently restructured into a more flexible interest rate option. Only one bank has to-date utilized the redesigned facility, in order to cover the equivalent of US$250 million of mortgage loans for 48 months. However, participation in the facility is only available once a year (during October), which limits the ability of banks to use this hedging tool exactly when needed. With regards to Law 794/2003 to streamline foreclosure proceedings, banks have reported recently a reduction in the time required to seize a property from about 50 to 32 months, although the sample on which this is based is relatively small.

71. **PFSAL II**: The government obtained a voluntary agreement from commercial banks to allocate a small portion of their loan portfolio (0.5 percent) to micro-housing finance either directly or through investments in FINDETER bonds. Based on Ministry of Housing calculations, the banking system had reached 95.0 percent of the micro-housing financing goal for 2005 as of March, an indication of growing interest in this type of financing, although banks met a significant portion of their commitment by purchasing FINDETER bonds (whose funds were then on-lent) rather than direct micro-housing lending.

72. With the mortgage securitization market growing in importance, the SB has developed new regulatory norms to address the risk profile of these instruments. Since MBS are issued with different classes representing different levels of risk, the SB issued risk weights for each security class based on external credit ratings, a procedure that is in line with the treatment of securitizations under the Basel II framework. This addressed any regulatory arbitrage concerns that a bank would sell its mortgages to the securitization company and retain the subordinated (i.e. highest risk) tranche of the MBS while minimizing

its capital requirements; under the new norms, the securitization would result in a reduction of regulatory capital for the bank that is commensurate with the actual risk reduction in its portfolio. At the same time, the SV introduced a risk-based capital adequacy regulation to cover the credit and market risks incurred by securitization companies, which conforms to the same standards applied by the SB. This new rule applies to *Titularizadora Colombiana*, the sole securitization company that is currently active in Colombia. However, one of the remaining longer-term policy issues regarding MBS is its income tax exemption status that was originally imposed to encourage the market's development. The tax-exempt status has motivated originating banks to retain the newly issued securities, thus in effect swapping a taxable for a non-taxable asset of equal face value. The resulting market distortion has prevented institutional investors such as pension funds from investing in MBS in spite of the market's size and expected growth following the pension reforms; this is because the price of MBS incorporates a premium reflecting its tax-exempt status for banks, which results in an unattractive yield for pension funds.

Component III: Non-bank Financial Institutions

73. **PFSAL I: Insurance companies**. More flexible regulatory powers were provided for the oversight and calculation of insurance companies' solvency margins and technical reserves. An increase in the minimum capital requirement was mandated for both insurers and re-insurers; however, the issuance of new insurance solvency regulations (including for technical reserves) has been encountering industry resistance due to its allegedly cumbersome requirements and overly technical sophistication. As a result, only the value-at-risk (VAR) methodology is currently applied to the insurance companies' investment portfolio. The SB is currently in the process of implementing a new system for the analysis and reporting of all insurance risks (underwriting, actuarial, market, credit, operational, and reputational).

74. **PFSAL II: Investment portfolio of insurance, trust, and pension companies**. The SB and SV have issued uniform regulations for insurance, trust, and pensions companies to report the market risk of their investment portfolios using a VAR methodology. This methodology is in the initial phase of implementation, with the SB currently reviewing the accuracy of the information being provided by industry participants. At the same time, both the SB and SV are evaluating the format for public disclosure of the information on VAR by investment funds. With respect to AFP investments, the SB has issued new rules raising the ceiling on foreign investments to 20 percent of their investment portfolio, and limiting investments in securities of related companies to 10 percent of their investment portfolio.

Component IV: Capital Markets

75. **PFSAL I:** A memorandum of understanding was signed between the SB and SV to harmonize the regulatory framework and undertake joint supervision and surveillance of mutual funds that are subject to both banking and securities supervision. A collaborative inter-institutional agreement between the SB, SV and the Central Bank established a common financial asset valuation methodology and a unified mark-to-market regulation for different fund types, which will mitigate mispricing weaknesses in the financial system that were at the core of the 2002 TES mini-crisis.

76. **PFSAL II:** Important measures included the harmonization of prudential capital requirements for the various collective investment schemes operating in Colombia, and mark-to-market valuation methodologies and disclosure requirements for mutual funds subject to the SV's supervision. While similar valuation rules were issued as part of the first Operation for government securities, under PFSAL II the rules were extended to include the valuation of private sector fixed income securities. With regards to disclosure requirements, the SV issued norms in the form of standardized "fact sheets" that mutual funds

must disclose to the public, which include financial, management, credit rating, and other performance information.

77. A new Securities Law (Law 964 of July 2005), whose presentation to Congress had been a key condition of PFSAL II, was approved that sets the framework for the capital markets in Colombia (see Box below for details). The new Law establishes (i) norms for corporate governance; (ii) rationalized requirements to lower the cost of issuance of securities while setting information disclosure requirements; and (iii) entry qualification standards for industry professionals wishing to conduct securities business.

Key Features of New Securities Law

Definition of supervisory powers: the Law gives SV the power to supervise all participants in the securities markets, including issuers, intermediaries that conduct securities transactions, stock exchanges, and operators of clearing and settlement facilities. The Government has the authority to determine what constitutes a security. A regime of sanctioning powers and penalties for market misbehavior is established.

Custody, clearance and settlement regulations: the Law establishes the principle of finality and makes clear the obligations of parties in a concluded securities transaction. The Law also provides for the establishment of a central counterparty risk clearing house in order to reduce the risks of market transactions.

Regulation of intermediaries: The Law allows stock exchanges, brokers and other intermediaries to self-regulate under norms approved by the SV. Qualifications and fit-and-proper standards are applied for securities industry professionals.

Shareholder protection: The Law introduces a number of corporate governance standards that are designed to protect the rights of minority shareholders. These include: a quarter of Board members have to be independent directors, corporations must have an audit committee where all independent directors are members, and public disclosure is required for any investor agreements.

Component V: The Government Debt and Money Markets

78. **PFSAL I:** In an effort to boost the liquidity of the government securities market and to provide an accurate methodology for the valuation of a range of other securities, the Government developed a framework to construct a zero coupon yield curve. Based on existing debt instruments, a yield curve was developed that covers up to 10 years in maturity. The reform also authorized the Central Bank to purchase and exchange 'on-the-run' treasury securities, i.e. those in the current window of issuance.

79. **PFSAL II**: The government established a new issuance program that relies on weekly T-bill auctions of progressively greater size. The strategy has initially focused on the 90-day T-bill, with weekly issuance increasing from 5 billion pesos in January 2003 to 80 billion pesos by mid-2004. Each issue split into equal weekly installments in order to allow the market to digest the offering while providing a running 90 day instrument. In addition, an Internal Committee for Public Debt Policy comprised of Senior Ministry and Central Bank officials was established in order to exchange information on market conditions and to advise the Finance Minister on the development of debt management policy.

4.3 Net Present Value/Economic rate of return:

Not applicable

4.4 Financial rate of return:

Not applicable

4.5 Institutional development impact:

80. **The Program's contribution to institutional development for all relevant line agencies has generally been substantial and multifaceted**. With respect to the bank regulation and resolution component, the passage of Law 795 has elevated the sophistication of the regulatory environment and risk-based supervisory procedures (SB), and has introduced new bank resolution techniques (FOGAFIN). The housing finance component has supported the creation of a mortgage securitization market (SB and SV), while the capital and government debt market reforms have cultivated greater cooperation between the primary supervisors (SB and SV) and have substantially strengthened securities regulation (SV) and the institutional arrangements for public debt management (MoF). By contrast, progress with regards to the non-bank financial institutions component has been less pronounced (SB) given the limited progress attained in implementing new solvency requirements for insurance companies.

Assessment of Institutional Development Impact of PFSAL II

81. **The institutional development impact of PFSAL II is deemed Substantial, particularly given its positive contribution to bank regulation and resolution as well as capital and debt market development issues**. The bank regulation and resolution component continued to strengthen risk-based supervisory practices such as the application of risk-based disciplinary rules and the development of new norms for the evaluation of risks associated with financial groups (SB). In addition, the component supported the establishment of a new resolution technique for insolvent banks that has not yet been utilized as no bank failures have been experienced (FOGAFIN). New rules regarding uniform prudential regulations and public disclosure of collective investment schemes and the establishment of a public debt committee and yield curve development strategy have also greatly improved the capacity of the relevant agencies (SV and MoF respectively).

5. Major Factors Affecting Implementation and Outcome

5.1 Factors outside the control of government or implementing agency:

82. **Factors affecting the Program and PFSAL I**. Economic factors outside the control of the government played an influential role in determining the outcome of the Program. The main such factor – correctly identified in the Program document – was slow economic growth driven by external shocks in Colombia's principal export markets (Venezuela and USA) that could compromise the pace of domestic recovery; this, in turn, could have knock-on effects on Colombian sovereign debt spreads and could therefore compromise fiscal performance. With the recovery of the world economy from the 2001-2002 recession, growth of external demand has supported a rate of economic growth that was higher than anticipated during the Program's preparation. A stronger domestic economy has in turn contributed to the improved health of the financial system as shown by the outcome indicators. The potential for increased internal violence was another potential factor that could have had economic ramifications but did not

materialize.

83. **Factors affecting PFSAL II**. As with the overall Program, external economic factors were instrumental – and played a positive role – in the outcome of the second operation. The success of the government's campaign against internal violence also contributed to greater confidence in the economy and thus to increased investment activity, which further buttressed financial sector activity. On the other hand, the lingering memories from the housing finance crisis of 1998-1999 still discouraged both demand and supply of mortgage financing.

5.2 Factors generally subject to government control:

84. **Factors affecting the Program and PFSAL I.** A key factor in the successful outcome of the first operation was the Government's strong commitment to the reform process in the financial sector and high degree of cooperation with the relevant line agencies. The success of the earlier FSAL was ample evidence of this long-standing commitment to improving economic growth through financial sector reforms. At the same time, the Government's adept handling of the banking crisis through a quick response and effective management – while maintaining overall fiscal discipline – contributed to the reliability of implementation capacity for this Program. This has been complemented by the austere monetary policy of the Banco de la Republica, which brought inflation down to 5.5 percent in 2004 from 16.7 percent at the height of the crisis in 1998 (see Selected Economic Indicators table in section 10). More stable inflation has also contributed to lower inflation-adjusted interest rates as seen by the downward shift in the government yield curve since 2003. Thus, a good track record on economic management helped to create a viable environment for financial sector reforms. Nevertheless, it is worth noting that the Government still faces significant challenges in reducing the overall size of public debt.

85. **Factors affecting PFSAL II**. The government's track record on economic management was even stronger during the implementation of PFSAL II than in PFSAL I. In addition, the government's continued commitment to financial sector reforms has enabled progress along several different fronts and was evident more recently in the prompt passage of the new Securities Law through Congress in mid-2005 and in the sale of GRANAHORRAR to the private sector on 31 October 2005.

5.3 Factors generally subject to implementing agency control:

86. **Factors affecting the Program and PFSAL I.** The strong commitment of the relevant line agencies (SB, SV, FOGAFIN) and of the MoF was also conducive to the Program's satisfactory and timely results. In addition, the SB has exhibited commendable realism in deciding to adjust earlier timetables for implementing new prudential regulations in a more gradual manner (e.g. the verification of new bank credit risk management models under SARC); this was influenced by pragmatic capacity/implementation considerations both for themselves and for their supervised entities. Nevertheless, progress in the implementation of new insurance solvency regulations under the non-bank financial institutions component has been incomplete and needs to accelerate going forward.

87. **Factors affecting PFSAL II**. Continuity of staff and strong ownership of the Program by the MoF and relevant line agencies contributed to the success of PFSAL II. The high technical competence of staff in these agencies was a determining factor in the successful outcome of the second Operation, although there is some concern about the recent turnover among technical staff experienced in the SB, as well as by any potential repercussions from the forthcoming merger of the SB and SV.

5.4 Costs and financing:

88. **The Program's financial resources were comprised of two one-tranche Operations that were disbursed as follows: US$150 million for PFSAL I and US$100 million for PFSAL II**. These funds were used to assist in meeting the government's budgetary financing needs. Since the external financing requirements for 2004 were below the original projections, the financing from the current Operation helped to reinforce foreign exchange reserves and to reduce the amount of internal debt issuance by the government.

6. Sustainability

6.1 Rationale for sustainability rating:

89. **The sustainability of PFSAL II components is rated as Likely in light of the positive aforementioned outcomes to-date, continued government commitment to – and Bank involvement in – financial sector reforms, and an improved macroeconomic environment**. The SB has already implemented most of the regulatory measures that are related to Law 795-2003, and is likely to continue (albeit at a slower pace driven by capacity considerations) the implementation of the SARC and SEARS programs. The government is currently in the process of privatizing *GRANAHORRAR* and early indications are very promising, while the financial performance of *GRANBANCO* has improved considerably. While housing finance has been slow to recover, the creation of a mortgage securitization market and the recent pick-up experienced in other types of lending are positive developments. The reform of the legal framework of capital markets under PFSAL II will now need to be translated into effective regulations. In this regard, a forthcoming Bank Programmatic loan series (Business Productivity and Efficiency Development Policy Loans) and on-going FIRST grant work supported by the Bank will continue to support capital markets development and leverage additional financial sector reforms to expand access to financial services in a sound manner and enhance the country's competitiveness. In addition, the World Bank is currently engaged in policy dialogue with the authorities via a program of financial sector Non-Lending Technical Assistance that potentially includes substantial follow-up work in the legal and regulatory frameworks for the financial system structure, pensions, credit reporting systems and creditor rights and corporate insolvency.

90. **A short-term risk factor to the sustainability of the PFSAL II reforms is the planned merger of the SB and SV in early 2006**. The government is strongly committed to the integration of financial supervision within a single institution and has already established five working groups that are addressing the different aspects of the merger (labor issues, technology, budgets, manuals etc.). While the merger presents opportunities in terms of economies of scope and operations, it will involve bringing together two relatively distinct, complex agencies in terms of their operational practices, which has the potential of disrupting their normal supervisory activities and delaying the ambitious reform agenda that has been supported by this Program. There is already some concern about the recent loss of technical staff (particularly on risk management issues) in the SB.

91. **Medium term macroeconomic risks and the upcoming elections could also affect the sustainability of PFSAL II and of the overall Program**. A notable slowing of economic growth and perhaps a recession could discourage further financial deepening, worsen the government's fiscal position and adversely affect the quality of the banks' assets. This is particularly important in light of the relatively high level of Colombia's public debt (around 50 percent of GDP) and the banking system's continued dependence on the public sector for its profitability and solvency (public sector exposure accounts for around 25 percent of bank assets). In addition, the upcoming Presidential elections might - if they result in a change in government priorities or in political turbulence - adversely affect (but are unlikely to derail)

intended financial sector outcomes. While important, these risks are not considered at present an imminent threat to the sustainability of the reforms supported by PFSAL II.

6.2 Transition arrangement to regular operations:

92. Since PFSAL II was a single-tranche policy adjustment loan, no transition arrangements were necessary.

7. Bank and Borrower Performance

Bank

7.1 Lending:

93. **Bank performance in the identification, preparation assistance, and appraisal of PFSAL II is considered Highly Satisfactory.** Both in the identification phase of the Program and in PFSAL II, the Bank showed sound judgment in selecting the targets drawing on existing analytic work, previous loan experience as well as comparable reforms undertaken in other parts of the region. The identification of the overall Program matrix showed a balance between complexity of reforms and implementation capacity and relevance in terms of the principal challenges facing the financial sector. While it can be argued that the design of the Program was complex and somewhat ambitious for a Program consisting of only two operations, it was compatible with the Borrower's capacity and supported an existing ambitious financial sector government reform package. The first Operation focused on institutional reforms with greater attention paid to the banking system, while the second focused on the implementation of those reforms and the upgrading of the legal framework of the capital markets. In general, the Program and the corresponding second Operation were well designed, consistent with the Bank's country strategy and supported by a stable macroeconomic environment.

7.2 Supervision:

94. **Bank supervision of PFSAL II is considered Satisfactory.** Effective Bank supervision was instrumental in identifying the areas that needed more attention in the design of PFSAL II in order to ensure the success of the overall Program. The Bank's emphasis on caution in the implementation of new regulatory schemes such as SARC was helpful in getting the SB to make a careful evaluation of the resources needed to apply these new practices effectively. However, the broad range of financial sector reforms that was covered by the five components potentially overstretched scarce team resources and made more difficult the supervision of all Program components with the same level of attention, although continued Bank support through other operations (banking supervision and housing finance policy dialogue, FSAP, FIRST-funded money market development project) partly alleviated this limitation.

7.3 Overall Bank performance:

95. **In light of the aforementioned comments, overall Bank performance for PFSAL II is considered Satisfactory**. The authorities have been very complimentary of the team's work in the financial sector, and this is also reflected in continuing involvement in financial sector reform via programmatic lending and AAA work. The Bank itself has also made a conscious effort to maintain continuity in staff in order to facilitate the dialogue on complex policy reforms and effectively coordinate various financial sector support initiatives in Colombia.

Borrower
7.4 Preparation:

96. **Borrower performance in the preparation of PFSAL II is considered Satisfactory**. Decisive government support of the Program and adherence to a firm and comprehensive agenda of reforms in the financial sector contributed to the smooth process of design and implementation of PFSAL II. Senior staff at the Implementing Agency (MoF) as well as the staff of key line agencies such as the SB, SV and FOGAFIN, as well as the Central Bank, were closely involved in the design of this Operation and also of PFSAL I. The three financial sector supervisory agencies maintained a broad and positive policy dialogue with the Bank during the design of this Operation.

7.5 Government implementation performance:

97. **Borrower performance in the implementation of PFSAL II is considered Highly Satisfactory**. The government's successful implementation of the macroeconomic policy agenda helped in setting the stage for a successful Operation. The passage of the new Securities Law with minimal changes and the recent successful privatization of *GRANAHORRAR* are tributes to the government's commitment to these reforms.

7.6 Implementing Agency:

98. **Performance of the implementing agency (MoF) and its partners (SB, SV, FOGAFIN) in PFSAL II was Highly Satisfactory**. In spite of early concerns about implementation capacity, a series of wide-ranging, comprehensive and often complex financial sector regulations and other policy measures was implemented successfully under PFSAL II. This would have been impossible without the strong leadership and coordination role of the MoF, as well as the technical capabilities of – and collaboration between – the relevant line agencies.

7.7 Overall Borrower performance:

99. In light of the aforementioned comments, overall Borrower performance is considered Highly Satisfactory.

8. Lessons Learned

- **Improvement in macroeconomic performance is an essential precondition for the successful implementation of a financial sector reform program**. The Government's success in containing the fiscal deficit, bringing down inflation and resuming growth over the past two years has helped to stabilize the financial system and has contributed significantly to the positive outcomes under PFSAL II.
- **Implementation of sophisticated methodologies for risk management has to proceed at a pace commensurate with local capacity and the market environment**. In the case of the credit risk models under SARC, the SB had to provide detailed guidance and await the building up of internal capacity and competency in the supervised financial entities before the process could be implemented in a successful manner. Likewise, the internal capacity constraints on the part of the SB to implement such changes were an important consideration, since the introduction of sophisticated risk management regulations led to the poaching of many of its technical staff by private sector banks. The World Bank was helpful in pointing out and assisting in thinking through these critical institutional needs.
- **Programmatic lending provides the Bank with more flexibility in supporting the Government's reform agenda and permits the build-up of a broader policy dialogue**. The shift in emphasis of PFSAL II prior actions compared to PFSAL I reflected both the embedded flexibility and

broad menu of policy reforms that was covered. In addition, the stocktaking report provided useful policy recommendations that were not originally contemplated in the Program policy matrix and that further enhanced the implementation of PFSAL II. The continuity of much of the team across both loan operations also greatly helped foster the policy dialogue.

❖ **A comprehensive and complex policy reform agenda, such as the one supported by this PFSAL, might have been better served by a Program consisting of more than two loan operations**. Since the banking sector has been the dominant component of the financial system, supporting the sound and sustainable recovery of banks, especially after the 1998-1999 bank crisis, was an important priority for this PFSAL. This was achieved by a series of policy measures primarily in the banking, housing finance, and capital and debt markets components. By contrast, the support provided by the Program to the insurance, pensions, trust and housing microcredit industries represents arguably a more complex and longer-term separate goal that could potentially have been better addressed via a third programmatic operation that focused on the development of non-bank financial intermediation and access to housing credit.

9. Partner Comments

(a) Borrower/implementing agency:

Libertad y Orden

Ministerio de Hacienda y Crédito Público

República de Colombia

Resultados de los Programas Sectoriales de Desarrollo del Sistema Financiero

Durante los últimos años, el Banco Mundial, en el marco de los Programas Sectoriales de Desarrollo del Sistema Financiero, ha acompañado a nuestro país en la puesta de marcha de importantes reformas que propugnaban por el desarrollo y fortalecimiento del mercado financiero colombiano. Así, los Créditos Programático de Ajuste al Sector Financiero apoyaron las acciones más importantes que el Gobierno puso en marcha, a partir de la crisis financiera de 1998-99.

Como resultado de muchas de estas acciones, el sector financiero ha consolidado su recuperación, la cual se viene dando desde finales del año 2001. A septiembre de 2005 las ganancias del sistema financiero sumaron 2,73 billones de pesos, lo que representa un crecimiento anual de 31.1%. Estos resultados positivos le han permitido a la banca recuperar los niveles de rentabilidad, solvencia, calidad de cartera, entre otros, observados antes de la crisis. Al mismo tiempo, les ha permitido fortalecer sus sistemas de manejo de riesgo y autorregulación.

Lo anterior, en el contexto de condiciones macroeconómicas externas e internas favorables que han permitido que continúe la sólida expansión del sistema financiero colombiano. La demanda mundial y el incremento de los precios de los productos básicos, así como el repunte del consumo de las familias y de la inversión empresarial, han jugado un papel determinante en la estabilidad y crecimiento del sistema financiero. De esta forma, las entidades que conforman este sector están acompañando el proceso de reactivación de la economía, debido a que su actividad no puede desligarse del desempeño económico.

Cabe anotar que los Programas de Ajuste al Sector Financiero, desde sus orígenes, tuvieron como objetivo acompañar al Gobierno de Colombia en el proceso de ajuste del sector financiero, quien en el marco de estos programas puso en marcha acciones relacionadas con las áreas de fortalecimiento de la regulación y supervisión bancaria, esquemas de resolución de entidades, programas de racionalización para la banca pública, creación de mecanismos para la financiación de programas de vivienda, apoyo al desarrollo del mercado de valores y de deuda pública y, en general, acciones para fortalecer el sector cooperativo y los mecanismos de apoyo previsto durante la crisis de 1998-99.

A manera simplemente enunciativa cabría mencionar que el Gobierno Nacional, a través del Ministerio de Hacienda y Crédito Público, participó en la preparación y trámite del proyecto de reforma financiera del año 1999, hoy Ley 510. Esta Ley, le otorgó facultades al Gobierno Nacional para dictar normas que adecuen la regulación prudencial a los parámetros internacionales, con el objeto de continuar avanzando en la adopción de recomendaciones como las del Comité de Basilea. Igualmente, introdujo algunos ajustes a las normas legales en materia de ingreso al sistema financiero y de manejo de situaciones de crisis para permitir que las autoridades puedan proteger adecuadamente el ahorro del público.

Igualmente, se participó en la redacción y presentación de la Ley Marco de Vivienda (Ley 546 de 1999) la cual creó un nuevo sistema de financiación de vivienda que respondía a los pronunciamientos de la Corte Constitucional en relación con esta materia. La Ley significó una modificación a la estructura de financiación de vivienda e implicó el reordenamiento del negocio y de su regulación al incorporar instrumentos de crédito de largo plazo para facilitar el acceso al crédito hipotecario en condiciones de equidad y de acuerdo con la capacidad de pago de los deudores y mecanismos para fomentar el ahorro destinado a vivienda. Igualmente, promovió la profundización del mercado de capitales creando instrumentos mediante los cuales se canalicen ahorros de largo plazo hacia el financiamiento hipotecario. Hizo más transparentes los sistemas de amortización, incorporó mecanismos de cobertura de riesgo y, en general, definió aspectos relacionados con costos, fuentes de recursos y el régimen de transición hacia el nuevo esquema.

Luego de la expedición de estas leyes, el Gobierno Nacional desarrolló y reglamentó las mismas. En el caso de la ley de vivienda buscó brindar un marco normativo claro y coherente para lograr un sistema de financiación de vivienda viable en el largo plazo que permitiera la reactivación de la construcción y del crédito hipotecario, adecuándose a los parámetros fijados por la Corte Constitucional en sus sentencias sobre la constitucionalidad de dicha Ley. En el caso de la reforma financiera, desarrollando y precisando los aspectos prudenciales incorporados en dicha ley, así como los nuevos instrumentos puestos a disposición de los entes de regulación y control, para evitar y enfrentar las crisis financieras.

Posteriormente, y enmarcado en los cinco componentes del Programa de Ajuste del Sector Financiero, el Gobierno Nacional desarrollo e implementó nuevas medidas cuyos logros han permitido afianzar el fortalecimiento del sistema descrito anteriormente. Los componentes y las principales acciones adelantadas se recogen a continuación:

I. Regulación y Resolución Bancaria

Bajo el Programa FSAL I, el Gobierno Nacional trabajó en un nuevo proyecto de reforma financiera que permitiera ajustar el contenido de las normas a los parámetros fijados para el correcto desempeño de los mercados financieros, el cual culminó con la expedición de la Ley 795 / 2003. Esta Ley realizó algunos ajustes al Estatuto Orgánico del Sistema Financiero, con la finalidad de modernizar algunos aspectos de la legislación vigente, flexibilizar rigideces de la normatividad, corregir debilidades evidenciadas en el proceso de reacomodamiento del sector financiero, introducir mecanismos de protección a los usuarios del sistema, introducir nuevos instrumentos para proteger la confianza del público en las entidades financieras, y adecuar algunas normas a pronunciamientos de la rama jurisdiccional.

Posteriormente, y en el marco del Programa FSAL II se surtió el trámite de la reglamentación de la Ley 795 / 2003 con el fin de solucionar algunos inconvenientes que presentaba el marco regulatorio del sistema financiero Colombiano. Sin lugar a dudas, su implementación significó mayor solidez patrimonial para muchas entidades del sector.

Igualmente, la Superintendencia Bancaria, SB, desarrolló un nuevo modelo de administración de riesgo, con el cual se busca mejorar los modelos actuales de cálculo de exposición al riesgo de crédito, incorporar los riegos de mercado que se originan en las operaciones de intermediación financiera y de tesorería, y garantizar que en todo momento las instituciones financieras van a mantener niveles de capital suficientes para soportar los riesgos a los que se encuentran expuestas. Actualmente, la SB está terminando de desarrollar los modelos estándar de medición de riesgo para los distintos tipos de cartera y va a comenzar a revisar los modelos internos desarrollados por algunas entidades financieras.

Con respecto al mecanismos de resolución bancaria y, en el marco de la política de racionalización de la banca pública, es importante mencionar que la mayoría de activos de bancos oficializados fueron liquidados por parte de FOGAFIN. Sin embargo, aún existen dos entidades sobre las cuales el gobierno continúa con el proceso de mejora administrativa y de cartera así como con el desarrollo de un plan estratégico para la venta o disposición de GranBanco-Bancafé y Granahorrar.

II. Financiación de la Vivienda

En el tema de vivienda, el Gobierno diseñó nuevos mecanismos para contrarrestar los factores que afectan la demanda de crédito y el riesgo en que incurren las entidades crediticias, sin desconocer los ajustes introducidos en la Ley de Vivienda que significaron una profunda modificación a la estructura de financiación de vivienda e implicaron el reordenamiento del negocio y de su regulación.

En este contexto, y como parte del Programa FSAL II, se estableció el Fondo de Reserva para la Estabilización de la Cartera Hipotecaria - FRECH, mecanismo creado para cubrir el riesgo de los establecimientos de crédito hipotecario del diferencial entre la tasa de interés y la inflación, cuyo esquema de operación esta operando en el mercado.

Igualmente, la autorización que el Gobierno otorgó a la Financiera de Desarrollo Territorial, FINDETER para celebrar operaciones de redescuento con el sector financiero dirigidas a la financiación de operaciones de crédito o microcrédito inmobiliario cuyo fin sea la construcción, remodelación o adquisición de vivienda de interés social, instrumento que ha promovido el desarrollo regional y urbano y ha permitido a segmentos de la población de bajos ingresos acceder a una vivienda digna.

Posteriormente, y en el marco del Programa FSAL II se fomentó el micro -crédito de vivienda y se mejoró la regulación de las compañías titularizadoras. En el primer caso, mediante la implementación de un programa de seguros a los créditos de personas con bajos ingresos a través del Fondo Nacional de Garantías. En el segundo caso, mediante la expedición de regulación que fijó para las compañías titularizadoras un capital mínimo basado en riesgos, el cual busca cubrir a dichas compañías de los riesgos de crédito y de mercado.

III. Instituciones Financieras No Bancarias

Para el sector asegurador y por iniciativa del Gobierno Nacional, se previó en la Ley 795 de 2003 una serie de modificaciones a la estructura legal que gobierna la actividad aseguradora que flexibiliza el esquema regulador de dicho sector, asegurando una atención inmediata del mismo mediante nuevas facultades de intervención del ejecutivo. De igual forma, se ajustó la legislación a los estándares internacionales en la búsqueda de dos efectos: de un lado, permitir el desarrollo de nuevos productos de seguro dentro de un marco jurídico que permita un adecuado grado de protección a los tomadores y asegurados y de otro, lograr que las compañías de seguros nacionales encuentren un adecuado sustento regulatorio para el cumplimiento de sus objetivos empresariales a nivel internacional.

Por su parte, en el marco del Proyecto SFAL II, se plantearon una serie de modificaciones a las industrias de valores y de pensiones, en temas como reformas en las inversiones de los fondos de pensiones en títulos en el extranjero.

IV. Mercado de Capitales

En este componente, cabría destacar el trabajo desarrollado durante el trámite del proyecto de Ley del Mercado de Valores. Este proyecto se convirtió en una necesidad del mercado debido al fenómeno de la globalización de los mismos y a la competencia y nuevas tecnologías en informática y comunicaciones que fomentaba un vertiginoso desarrollo de los mercados de valores alrededor del mundo, lo cual determinó la necesidad de ajustar el esquema regulatorio a las nuevas formas de negocios y a los nuevos riesgos involucrados.

Como parte del FSAL II, se presentó al congreso la Nueva Ley de Mercado de Valores, la cual incorporó aspectos para regular las actividades de manejo, aprovechamiento e inversión de recursos del público que se efectúen mediante valores, con el fin de proveer al país de un marco legal coherente, actualizado, moderno y flexible, que organice las distintas autoridades, instituciones y agentes del mercado de valores de manera armónica; proteja los derechos de los inversionistas; promueva el desarrollo, eficiencia y funcionamiento; y preserve la confianza del público.

Este proyecto es hoy Ley de la República y el Gobierno esta iniciando su proceso de reglamentación. Los aspectos más relevantes contenidos en dicha Ley son: normas de gobierno corporativo, poderes de supervisión por parte de la Superintendencia de Valores, regulación de los intermediarios, armonización de la regulación de los fondos mutuos, nuevas estándares de valorización de títulos valores, profesionalización de los participantes en el mercado, entre otras.

V. Mercados de Deuda Pública

La estrategia de endeudamiento de la Nación se ha orientado hacia la diversificación de fuentes de financiamiento, resaltando la importancia de contar con un mercado doméstico sólido y profundo para evitar la vulnerabilidad frente a choques externos. En este contexto, el desarrollo de una estrategia de emisión de deuda pública ha permitido que Colombia cuenta con una de las curvas de rendimiento más desarrolladas en toda la región y, se mantienen los esfuerzos por consolidar el mercado de deuda pública interna a través del fortalecimiento del mercado de TES el cual ha alcanzado niveles importantes de liquidez y profundidad.

Sobra anotar, que adicional a estas medidas, el sector cooperativo financiero, el mercado de valores, la banca pública y, en general, el sector financiero, han sido objeto de un permanente seguimiento con el fin de proponer y realizar ajustes normativos necesarios para promover su desarrollo y adecuar nuestra normatividad a los estándares internacionales, tanto en el ámbito del mercado de capitales como en el del mercado intermediado. Así mismo, estableciendo políticas que propicien estabilidad y claridad en las reglas que regulan la actividad financiera, estableciendo derroteros en materia de regulación.

Como resultado de muchas de estas acciones, las carteras crediticias de los bancos presentan uno de los niveles más altos de crecimiento de los últimos años, jalonado principalmente por el crédito comercial, dado el dinamismo de los recursos dirigidos a las PYMES, y el crédito de consumo, dada la mayor confianza de los hogares y la recuperación de la demanda agregada. La calidad de cartera se sitúa en los niveles antes de la crisis financiera, como consecuencia del mayor esfuerzo en provisiones y el saneamiento de los balances. El nivel de solvencia del sector se mantiene en niveles altos, evidenciando mayor capacidad de ofrecer recursos, dada su solidez patrimonial. Y, estos buenos resultados les ha permitido recuperar a la banca sus niveles de rentabilidad observados antes de la crisis de 1998-99.

A pesar de este evidente proceso de recuperación, es necesario anotar que el sistema y en general el Gobierno aún enfrentan retos significativos, particularmente aquellos relacionados con el fortalecimiento institucional de las autoridades de regulación y supervisión así como, aspectos que propendan por la profundización financiera. Lo anterior, sin perder de vista los cambios que se están dando en la estructura del sector financiero, dado los procesos de fusiones y adquisiciones que buscan eficiencia e incremento en la cobertura por el uso eficiente de las redes y líneas de negocios bancarios que, en últimas, redundará en beneficio de los usuarios por la posibilidad de acceso a servicios financieros.

Por lo anterior, y con el fin de consolidar estos objetivos, el Gobierno Nacional continúa promoviendo acciones en esta dirección y sigue comprometido con la integración adecuada entre el sector bancario intermediado y el mercado de valores, a fin de garantizar la estabilidad del mercado financiero.

Muchas de las medidas y políticas descritas anteriormente se desarrollaron en el marco de los Programas de desarrollo del sector financiero suscritas entre el Banco Mundial y el Gobierno colombiano por tanto, los resultados de desempeño positivo del sector financiero corroboran la bondad y oportunidad de estos programas y, nos permiten calificar los mismos como exitosos. El acompañamiento de la Unidad Ejecutora del Banco Mundial fue importante en la consecución de estos objetivos por tanto, resulta pertinente agradecer y reconocer el acompañamiento y compromiso permanente de los técnicos del Banco Mundial para el éxito de los Programas Sectoriales de Desarrollo del Sistema Financiero.

Cabría destacar, además, los resultados alcanzados al interior del Gobierno relacionados con la coordinación entre las distintas entidades nacionales con competencias en los dos programa, aspecto que contribuyo a finalizar exitosamente los mismos. En efecto, en cada uno de los dos programas no solo el Ministerio de Hacienda y Crédito Público tuvo responsabilidades directas en el cumplimiento de compromisos frente al Banco Mundial sino que otras entidades como las Superintendencias Bancaria y de Valores, FOGFIN, Viceministerio de Vivienda, Banco de la República, entre otros, acompañaron estos Programas de forma permanente.

Como se puede observar, el compromiso y coordinación permanente entre los técnicos del Banco Mundial y las distintas entidades del Gobierno, jugaron un papel fundamental en el desarrollo de dichos programas.

(b) Cofinanciers:

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

10. Additional Information

Table 8: Colombia – Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004	2005*
National income and prices								
Nominal GDP (USD billions)	91.1	80.9	83.8	82	81.6	80	97.4	112.3
Real GDP growth (% p.a.)	0.6%	-4.2%	2.9%	1.5%	1.9%	4.0%	4.0%	4.0%
CPI inflation (period average)	16.7%	9.2%	8.7%	7.6%	7.0%	6.5%	5.5%	5.0%
Nominal 90-day deposit rate (% p.a.)	34.1%	15.8%	13.4%	11.5%	7.7%	7.9%	7.7%	
Saving and investment								
Gross national saving (% of GDP)	14.3%	13.7%	14.6%	13.2%	12.6%	13.5%	12.9%	12.5%
Gross domestic investment (% of GDP)	19.6%	12.9%	13.7%	14.5%	14.2%	14.9%	14.0%	15.3%
External sector								
Trade balance (% of GDP)			3.1%	0.7%	0.3%	0.5%	1.0%	-1.3%
Current account balance (% of GDP)	-5.3%	0.2%	0.9%	-1.4%	-1.7%	-1.5%	-1.0%	-2.8%
Exchange rate COP/USD (end of period)	1,542	1,874	2,229	2,291	2,865	2,778	2,390	2,368
Gross international reserves (in months of imports)	6.6	6.7	6.8	8.0	7.8	6.6	7.2	6.5
Public sector								
Nonfinancial public sector - primary balance (% of GDP)	-1.3%	-2.6%	0.9%	1.5%	0.4%	1.7%	2.7%	2.7%
Nonfinancial public sector - overall balance (% of GDP)	-4.6%	-6.5%	-3.5%	-3.5%	-4.2%	-3.2%	-1.7%	-2.5%
Combined public sector balance (% of GDP)	-3.8%	-5.5%	-3.4%	-3.2%	-3.7%	-2.7%	-1.3%	-2.5%
Debt								
Total external debt (% of GDP)	36.3%	42.5%	46.1%	47.5%	52.3%	46.0%	37.1%	35.9%
Total public debt (% of GDP)	29.9%	39.8%	47.7%	51.7%	60.2%	56.0%	52.9%	50.4%
of which: domestic (% of GDP)			*21.4%*	*23.2%*	*28.3%*	*26.4%*	*28.8%*	*27.7%*
of which: external (% of GDP)			*26.3%*	*28.5%*	*31.9%*	*29.6%*	*24.1%*	*22.7%*

* 2005 figures are either projections or (where applicable) latest available

Source: IMF

Table 9: Colombian Banking System – Balance Sheet (in COP$ Million)

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Jul-05	As % of Total Assets
Liquid Assets	4,970,706	5,764,515	5,407,396	5,223,235	5,627,375	6,423,251	7,611,297	6,673,481	5.5%
Securities	9,387,825	12,065,639	17,165,071	22,163,053	25,069,639	29,004,197	37,147,426	38,876,945	32.1%
Net Loans & Leases	51,040,036	48,469,259	44,300,768	44,097,631	46,436,319	49,626,725	59,815,511	65,428,445	54.0%
Commercial - Gross	*28,188,034*	*28,156,877*	*27,732,713*	*27,829,868*	*31,072,238*	*33,381,563*	*42,213,989*	*45,197,471*	*37.3%*
Consumer - Gross	*9,531,192*	*6,853,447*	*6,665,979*	*7,458,271*	*7,854,750*	*9,586,725*	*12,673,771*	*14,894,256*	*12.3%*
Microcredit - Gross	*0*	*0*	*0*	*0*	*389,713*	*568,029*	*841,081*	*1,091,778*	*0.9%*
Mortgages - Gross	*15,478,889*	*16,004,606*	*12,853,196*	*12,404,667*	*10,914,861*	*9,626,295*	*7,087,884*	*7,227,185*	*6.0%*
Provisions	*(2,158,079)*	*(2,545,670)*	*(2,951,120)*	*(3,595,176)*	*(3,795,243)*	*(3,535,887)*	*(3,001,213)*	*(2,982,244)*	*-2.5%*
Other Assets	13,996,025	13,746,373	13,516,462	12,760,287	12,052,123	12,349,115	10,359,525	10,150,323	8.4%
TOTAL ASSETS	**79,394,592**	**80,045,786**	**80,389,697**	**84,244,205**	**89,185,456**	**97,403,289**	**114,933,759**	**121,129,194**	**100.0%**
Deposits	45,839,759	49,355,959	50,572,079	55,123,214	58,052,286	62,669,458	75,933,343	80,700,046	66.6%
Funding from Credit Institutions	14,171,614	13,799,519	13,676,457	12,589,425	13,779,877	15,950,110	15,629,002	15,561,945	12.8%
Debt Borrowing	6,366,231	4,114,781	2,871,277	2,526,418	2,480,850	2,241,236	3,367,844	3,914,800	3.2%
Other Liabilities	4,614,971	3,952,636	4,169,360	4,588,265	5,048,287	5,283,350	6,080,150	6,610,894	5.5%
TOTAL LIABILITIES	**70,992,575**	**71,222,894**	**71,289,173**	**74,827,323**	**79,361,300**	**86,144,154**	**101,010,338**	**106,787,685**	**88.2%**
Equity	8,402,017	8,822,892	9,100,524	9,416,882	9,824,156	11,259,134	13,923,420	14,341,509	11.8%
TOTAL LIABILITIES AND NET WORTH	**79,394,592**	**80,045,786**	**80,389,697**	**84,244,205**	**89,185,455**	**97,403,289**	**114,933,759**	**121,129,194**	**100.0%**

Source: Superintendencia Bancaria, World Bank analysis

Table 10: Colombian Banking System – Income Statement (in COP$ Million)

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Jul-05 (annualized)	As % of Total Assets
Interest Income from Loans & Leases	15,504,120	12,736,691	8,667,706	8,290,826	7,373,190	7,641,229	8,985,291	9,747,827	8.0%
Interest Income Past Due	*493,466*	*489,148*	*275,665*	*221,320*	*211,551*	*222,609*	*254,307*	*251,369*	*0.2%*
Interest Expense	(12,221,027)	(10,307,280)	(5,841,982)	(5,761,966)	(4,419,064)	(3,983,184)	(4,572,978)	(4,929,233)	-4.1%
Deposits	*(8,168,443)*	*(7,188,447)*	*(3,883,802)*	*(4,032,062)*	*(3,134,590)*	*(2,753,247)*	*(3,108,253)*	*(3,415,576)*	*-2.8%*
Funding from Credit Institutions	*(2,273,256)*	*(1,746,822)*	*(1,415,920)*	*(1,272,881)*	*(908,929)*	*(903,868)*	*(1,005,191)*	*(991,813)*	*-0.8%*
Debt Borrowing	*(1,603,611)*	*(1,200,674)*	*(431,289)*	*(356,532)*	*(280,411)*	*(219,414)*	*(298,606)*	*(327,647)*	*-0.3%*
Other	*(175,717)*	*(171,337)*	*(110,972)*	*(100,491)*	*(95,133)*	*(106,656)*	*(160,928)*	*(194,196)*	*-0.2%*
Net Interest Income from Loans & Leases	**3,283,093**	**2,429,411**	**2,825,724**	**2,528,860**	**2,954,126**	**3,658,045**	**4,412,313**	**4,818,594**	**4.0%**
Income from Securities	1,670,942	1,854,097	1,843,769	2,266,336	2,365,513	2,806,440	3,791,521	4,466,125	3.7%
Other Net Non-Interest Income	1,856,122	2,044,734	2,026,867	2,265,628	2,397,829	2,727,804	2,489,173	2,353,364	1.9%
Fees and Commissions	*1,178,534*	*1,376,426*	*1,585,401*	*1,701,949*	*1,891,341*	*2,085,167*	*2,223,131*	*2,342,973*	*1.9%*
Trading (FX, Derivatives)	*181,868*	*244,964*	*160,589*	*282,314*	*226,387*	*323,057*	*233,369*	*(22,742)*	*0.0%*
Leasing	*495,720*	*423,345*	*280,877*	*281,365*	*280,101*	*319,580*	*32,673*	*33,133*	*0.0%*
Gross Income	**6,810,156**	**6,328,242**	**6,696,360**	**7,060,825**	**7,717,468**	**9,192,289**	**10,693,007**	**11,638,083**	**9.6%**
Operating Expenses	(4,801,461)	(5,099,436)	(5,357,609)	(5,231,121)	(5,484,051)	(5,656,650)	(5,780,437)	(5,971,296)	-4.9%
Net Operating Income Before Depreciation and Provisions	**2,008,695**	**1,228,807**	**1,338,750**	**1,829,704**	**2,233,417**	**3,535,638**	**4,912,570**	**5,666,787**	**4.7%**
Depreciation and Amortization	(886,361)	(938,025)	(917,920)	(812,339)	(741,065)	(754,096)	(709,316)	(706,637)	-0.6%
Net Operating Income Before Provisions	**1,122,334**	**290,782**	**420,831**	**1,017,364**	**1,492,353**	**2,781,543**	**4,203,254**	**4,960,150**	**4.1%**
Net Provisions	(2,037,260)	(2,598,230)	(1,513,214)	(271,220)	159,786	(89,831)	(240,894)	(432,713)	-0.4%
Gross Provisions	*(2,786,165)*	*(3,973,116)*	*(3,337,535)*	*(2,212,664)*	*(1,854,525)*	*(2,027,134)*	*(2,199,519)*	*(2,138,541)*	*-1.8%*
Recoveries	*748,905*	*1,374,886*	*1,824,321*	*1,941,444*	*2,014,311*	*1,937,302*	*1,958,625*	*1,705,828*	*1.4%*
Net Operating Income After Provisions	**(914,926)**	**(2,307,449)**	**(1,092,383)**	**746,144**	**1,652,138**	**2,691,711**	**3,962,360**	**4,527,437**	**3.7%**
Inflation Adjustment	(215,018)	(126,621)	(123,858)	0	0	0	0	0	0.0%
Extraordinary Items	(482,820)	(165,390)	(357,871)	(239,922)	(303,478)	(281,333)	(187,306)	(44,697)	0.0%
Net Income Before Tax	**(1,612,764)**	**(2,599,460)**	**(1,574,113)**	**506,222**	**1,348,661**	**2,410,378**	**3,775,054**	**4,482,740**	**3.7%**
Income Tax	(330,126)	(211,288)	(282,077)	(403,916)	(429,613)	(605,177)	(875,071)	(1,129,093)	-0.9%
Net Income After Tax	**(1,942,890)**	**(2,810,748)**	**(1,856,191)**	**102,306**	**919,047**	**1,805,202**	**2,899,983**	**3,353,646**	**2.8%**

Source: Superintendencia Bancaria, World Bank analysis

Table 11: Colombian Banking System – Selected Financial Ratios

	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Jul-05 (annualized)
NOMINAL GROWTH RATES								
Gross Loans & Leases		-4%	-7%	1%	5%	6%	18%	15%
Deposits		8%	2%	9%	5%	8%	21%	11%
Total Assets		1%	0%	5%	6%	9%	18%	9%
AS % OF GDP								
Gross Loans & Leases	38%	34%	27%	25%	25%	23%	25%	24%
Deposits	33%	33%	29%	29%	28%	27%	30%	29%
Total Assets	57%	53%	46%	45%	44%	42%	45%	43%
SOLVENCY								
Net Worth/Total Assets	10.6%	11.0%	11.3%	11.2%	11.0%	11.6%	12.1%	11.8%
Capital Adequacy Ratio		10.9%	13.2%	13.3%	12.5%	13.1%	13.8%	14.4%
PROFITABILITY								
Return on Average Assets (ROAA)	-2.5%	-3.5%	-2.3%	0.1%	1.1%	1.9%	2.7%	2.8%
Return on Average Net Worth (ROAE)	-21.0%	-32.6%	-20.7%	1.1%	9.6%	17.1%	23.0%	23.7%
Net Interest Margin (Net Interest Income/Average Assets)	*4.1%*	3.0%	3.5%	3.1%	3.4%	3.9%	4.2%	4.1%
EFFICIENCY								
Cost-Income Ratio (Operating Expenses/Gross Income)	71%	81%	80%	74%	71%	62%	54%	51%
Operating Expenses/Average Assets		6.4%	6.7%	6.4%	6.3%	6.1%	5.4%	5.1%
ASSET QUALITY								
Past Due Loans/Total Gross Loans	10.7%	13.6%	11.0%	9.7%	8.7%	6.8%	3.3%	3.3%
Non-Performing Loans/Total Gross Loans		16.3%	16.4%	15.4%	13.6%	10.5%	5.8%	5.0%
Loan Loss Provisions/Total Gross Loans	4.1%	5.0%	6.2%	7.5%	7.6%	6.7%	4.8%	4.4%
Loan Loss Provisions/Non-Performing Loans		31%	38%	49%	56%	64%	82%	88%
Gross Loan Composition								
Commercial	*53%*	*55%*	*59%*	*58%*	*62%*	*63%*	*67%*	*66%*
Consumer	*18%*	*13%*	*14%*	*16%*	*16%*	*18%*	*20%*	*22%*
Microcredit	*0%*	*0%*	*0%*	*0%*	*1%*	*1%*	*1%*	*2%*
Mortgages	*29%*	*31%*	*27%*	*26%*	*22%*	*18%*	*11%*	*11%*
OTHER INDICATORS								
Public Sector Exposure	8,916,693	10,838,815	17,074,090	21,080,828	23,008,626	25,119,342	NA	NA
Public Sector Exposure/Total Assets	11.2%	13.5%	21.2%	25.0%	25.8%	25.8%		

Source: Superintendencia Bancaria, IMF

Annex 1. Key Performance Indicators/Log Frame Matrix

Colombia: Outcome Indicators for PFSAL II	
Expected Outcomes	**Latest Available Outcome Indicators**
MACROECONOMIC POLICY ENVIRONMENT – Policy Objective: Maintenance of a sound macroeconomic policy framework	
Increased economic growth and private sector investment	Real GDP growth of 4.0 percent in 2003 and 2004, which is higher than anticipated at Program's origination; private sector investment rose to 15.3 percent of GDP in early 2005 compared to 14.2 percent of GDP in 2002; inflation has dropped to 5.0 percent in early 2005, down from 7.0 percent in 2002.
Reduction of fiscal deficit and reliance on long term debt financing	Combined public sector deficit fell to 1.3 percent of GDP in 2004 (although this is expected to rise in 2005), down from 3.7 percent of GDP in 2002; public debt has dropped by 10 percentage points between 2002 and 2005, while its composition has shifted towards a greater proportion of domestic debt.
COMPONENT I: BANK REGULATION AND RESOLUTION – Policy Objective: Upgrading the Banking, Supervisory and Institutional Framework	
Stronger bank financials and increased financing activity	As per table 1 and section 10, profitability has improved noticeably, capital adequacy has remained high in spite of progressively stricter market risk capital requirements, loan quality has improved and banks have become more efficient
Identification and removal of conflicts of interest and related party risks	Conflicts of interest per the relevant regulation are being reported and scrutinized, although it is up to the SB itself to identify and review transactions between non-bank affiliates where ownership interest is less than 50 percent and are therefore not required to be reported
Early correction of adverse financial trends	SB has intensified the examination and application of disciplinary rules, with 36 resolutions of disciplinary actions in 2003, 62 in 2004, and 92 in Jan-August 2005; of these, the Appeals Group modified or revoked the following percentage of disciplinary actions: 15 percent in 2003, 22 percent in 2004 and 26 percent in Jan-August 2005
COMPONENT I: BANK REGULATION AND RESOLUTION – Policy Objective: Upgrading the Bank Resolution and Deposit Insurance Operational Framework	

Reduction of State interests in intervened financial institutions	A new bank (*GRANBANCO*) was formed from *BANCAFE* and is expected to be sold by 2007; pension liabilities remained with *BANCAFE* and that entity is in process of liquidation; the financial performance of this bank has improved substantially in recent years
	GRANAHORRAR – the bank was privatized on 31 October 2005 in an auction won by Spanish bank BBVA for an amount of 970 billion pesos; its financial performance has also improved substantially in recent years
	BANAGRARIO – its financial performance has improved substantially in recent years
	IFI – has been liquidated and its second-tier operations transferred to *BANCOLDEX*
Reduction of fiscal liabilities	Through FOGAFIN management, public sector liabilities arising from financial sector support operations have fallen from 6.3 percent to 2.6 percent of 2004 GDP (see table 2).
Successful bank interventions and deposit insurance	No actions to intervene a bank have been necessary during the period of the program
COMPONENT II: HOUSING FINANCE – Policy Objective: Upgrading the Regulatory/Operational Framework of the Mortgage Market and Improving Access to Credit	
Increased home ownership	Financial system credit to housing stood at 6.5 percent of GDP in 2003 and declined to 5.8 percent in 2004; however, it has partly recovered during the first half of 2005 (see table 3). Earlier figures on housing finance are available only for the banking system and (if one includes the securitized portfolio) show a mild decline over time.
	Quality of mortgage loan portfolio of the banking system has improved: non-performing mortgage loans as a percent of total mortgage loans fell from 24.6 percent in December 2002 to 8.6 percent in June 2005
	As per Table 3, UVR spreads for non-VIS loans have declined by about one percentage point between 2002 and 2004; given that inflation has also dropped over this time period, the absolute decline in mortgage borrowing rates has been even higher
Increased access to housing credit by underserved segments of the population (micro housing finance)	Micro housing finance is still minimal, as per the voluntary agreement between banks and the government (about 0.5 percent of banks' loan portfolio).
Reduced time to foreclosure of mortgaged properties	Time required to seize property in foreclosure is reported recently to have been reduced from about 50 to 32 months, although the relevant sample remains

	relatively small.
Development of risk management tools for the housing finance markets	One of the biggest mortgage banks (*DAVIVIENDA*) has purchased the interest rate option offered by FRECH to cover about US$250 million of its mortgage loans; however, no other bank has yet using this instrument
Sustainable growth of the primary and enhanced liquidity of the secondary mortgage market	By 2004, securitized mortgages represented 26.0 percent of total financial system credit to housing (see table 3).
COMPONENT III: NON-BANK FINANCIAL INSTITUTIONS (INSURANCE, PENSIONS, TRUSTS) – Policy Objective: Upgrading the Regulatory Framework for Risk Management and Capital Adequacy of the Non Bank Service Institutions	
Enhanced solvency of insurance industry	Solvency margins for the general insurance industry have increased from 41.3 percent in 2000 to 58.9 percent in 2004, and for life insurance from 38.8 percent in 2000 to 45.2 percent in 2004 (see table 4).
Orderly exit of non-viable insurance companies	The number of general insurance companies has decreased from 27 in 2000 to 24 in 2004; for life insurance, the number also decreased from 23 to 20; however, this does not necessarily reflect exit of non-viable insurance companies
Increased use of personal and property insurance	Slight increase in the premiums to GDP ratio for general insurance (See table 4).
Pension and trust companies are adequately capitalized with improved policies to manage financial risks	Disclosure of returns included in Fact Sheets published by each fund. However, regulators have not yet determined format for disclosure of market risk
COMPONENT IV: CAPITAL MARKETS – Policy Objective: Upgrading the Regulatory Framework for the Governance, Transparency, Operations and Liquidity of the Securities Market	
Increased issuance of securities	Issuance of new securities, particularly on the equities side, has declined during 2001 – 2004 (see table 6).
	Volume of trading in secondary market has increased significantly, but remains dominated by government securities (see table 6).
Enhanced integrity of securities market	Disciplinary actions by SV: 2002: 25 sanctions, of which 23 were fines and 2 involved revocation of registration. 2003: 19 sanctions, of which 16 were fines, 2 involved revocation of registration, and 1 suspension. 2004: 20 sanctions, of which all were fines
Increased participation in collective investment schemes	Size of pension fund assets relative to GDP increased from 9.6 percent in 2001 to 15.3 percent in 2005 (see table 5).

COMPONENT V: THE GOVERNMENT DEBT AND MONEY MARKETS – Policy Objective: Implementation of a Public Debt Issuance Strategy to Improve the Functioning of the Fixed Income Market	
Regular issuance program of domestic government securities and their increased trading leads to a reliable estimate of the yield curve	Short-term government securities issuance has been increased according to the public debt strategy plan. As of June 2004, Treasury made weekly issuance of 80 billion pesos. Starting in February 2005, a four week issue of 80 billion per week all with the same maturity date provided additional liquidity; these amounts were subsequently increased to 100 billion and then 120 billion per week. In October 2005, the government will introduce the 180-day TES.
	With the successful development of a more liquid short-term market for Treasury Bills, it has been possible to construct a reliable government securities yield curve that is made available through the Colombian Stock Exchange web site (see Table 7).
	Government has published a long-term calendar through December 2011 in order to provide guidance to the market on its scheduled issuance of securities by tenor

Annex 2. Project Costs and Financing

Not applicable.

Annex 3. Economic Costs and Benefits

Not applicable.

Annex 4. Bank Inputs

(a) Missions:

Stage of Project Cycle / Month/Year	No. of Persons and Specialty (e.g. 2 Economists, 1 FMS, etc.) Count	Specialty	Performance Rating: Implementation Progress	Performance Rating: Development Objective
Identification/Preparation				
8/2003	*4*	1 Team Leader, 1 Financial Officer, 1 Insurance Specialist, 1 Housing Finance Specialist		
12/2003	*3*	1 Team Leader, 1 Financial Officer, 1 Housing Finance Specialist		
2/2004	*3*	1 Team Leader, 2 Financial Economist,		
Appraisal/Negotiation				
8/2004	*3*	1 Team Leader, 1 Financial Economist, 1 Lawyer		
Supervision				
11/2004	*3*	1 Team Leader, 1 Team member and 1 Legal Specialist	S	S
12/2004	*3*	1 Team Leader, 1 Team Member and 1 Consultant	S	S
1/2005	*2*	1 Team Leader, 1 Sr.Financial Economist	S	S
ICR				
8/2005	*1*	Consultant who is preparing the ICR		
9/2005	*1*	1 Team Member		
10/2005	*1*	1 Team Leader		

(b) Staff:

Stage of Project Cycle	Actual/Latest Estimate: No. Staff weeks	Actual/Latest Estimate: US$ ('000)
Identification/Preparation	44.12	180.7
Appraisal/Negotiation	1	4.5
Supervision	5.67	18.5
ICR	10.7	31.9
Total	61.49	235.6

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

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

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

Annex 6. Ratings of Bank and Borrower Performance

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

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

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

Annex 7. List of Supporting Documents

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World Bank, *Stocktaking Report: The Recovery of Colombia's Financial System and Remaining Vulnerabilities*, July 2004.

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Miscellaneous correspondence and documents (including BTOR, ISR and PSR) in PFSAL project files.

Additional Annex 8. Policy Matrix for the Programmatic FSAL Operations

Policy Matrix				
PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	**TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL**	**RESULTS / OUTPUTS TO-DATE**	**PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL**	**EXPECTED OUTCOMES FROM 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 with appropriate fiscal, monetary, inflation and exchange policies.	Annual real GDP growth increased to 3.7% by end 2003, and external capital inflows rose while exports were up by 9%. Inflation declined to 6.5% and the combined public sector deficit fell to 2.8% of GDP as income tax receipts rose by 16%.	***The Borrower has maintained a stable macroeconomic environment through the implementation of sound fiscal, inflation and other policies including supplementary fiscal legislative and regulatory measures.***	Increased economic growth and private sector investment. 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	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	(i) The net return on average earning assets of the banking system increased from 1.1% at end-2002 to 2.7% by May 2004. (ii) The non performing loans ratio decreased from 13.6% to 9.2% during the same period. (iii) The capital adequacy ratio (capital as a % of risk weighted assets) increased from 12.5% to 14.5% during a period in which stricter capital and loan classification standards were implemented. (iv) The Banking Superintendency, between May 2003 and June 2004, applies fifty three sanction actions and penalties to credit institutions that were not complying with legal and prudential norms. The Banking Superintendent has approved a modified regulatory circular to incorporate procedures for monitoring, assuring oversig and conducting consolidated supervision of financial	***The Borrower: (a) through MoF has issued Decree Number 2588, dated August 13, 2004, to regulate, inter alia: (i) the orderly resolution of insolvent banks operating in the Borrower's territory; and (ii) the procedures for the transfer of assets (including the use of asset securitization vehicles) and liabilities from said insolvent banks to acquiring banks; (b) through SB has issued an Instructivo Interno, dated August 10, 2004, setting forth the guidelines for the application of disciplinary rules (including monetary fines) applicable to SB's supervised entities; and (c) through SB has published on SB's official website, on August 12, 2004, a new draft Circular Externa delineating banks' capital exposure risks within related economic and financial conglomerates.***	Banks and other credit institutions are well capitalized and providing increased credit to borrowers and private investors for new business start-ups and expansions. The sector is more competitive and is attracting foreign and direct investors. 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

Policy Matrix

PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL	RESULTS / OUTPUTS TO-DATE	PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL	EXPECTED OUTCOMES FROM THE PROGRAM
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.	group examinations, and the investment of resources for SB's institutional strengthening.	conglomerates, related party businesses, and computation of effective capital of financial institutions within conglomerates, and has subjected the draft regulation for review by the financial industry and the SV. The SB has developed its internal risk assessment procedures for evaluating vulnerabilities of supervised financial institutions and prioritizing the SB's inspection program. The SB has developed an action plan specifying the human, budgetary and time resources required to complete technical reviews of banks' internal credit risk management models which incorporate Basel II orientations, allowing for full implementation in a prescribed period commensurate with SB's human and budgetary resource base and capacity.		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.
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	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.	The Deposit Insurance Agency, FOGAFIN, has divested and sold banking assets previously in State hands. These include COP 9.8 billion (US$ 3.8 million) of GRANAHORRAR mortgage assets during 2003. The portfolio previously supported by State relief credits ('alivios') was sold in 2003 to 65,000 mortgage holders for COP 224 billion (US$ 86 million). Out of 480 real estate assets at the start of the year, 239 were sold.	***The Borrower: (a) through FOGAFIN has: (i) undertaken an international competitive bidding process for the sale of BANCAFE; and (ii) issued an Action Plan, dated August 12, 2004, for the continued financial improvement and eventual sale or divestment of BANCAFE and GRANAHORRAR; (b) through MCIT has issued Decree Number 2590, dated September 12, 2003, ordering the dissolution and liquidation of IFI and the partial transfer of IFI's assets and liabilities to BANCOLDEX, and***	Banks are operating safely and efficiently, increasing savings while channeling funds toward increased domestic investment. 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,

Policy Matrix				
PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	**TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL**	**RESULTS / OUTPUTS TO-DATE**	**PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL**	**EXPECTED OUTCOMES FROM THE PROGRAM**
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.	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.	A financial sector vulnerability analysis has been completed and endorsed by the SB with input from MOF and FOGAFIN. The assessment reviews past and current weaknesses of specified financial institutions, assesses potential macroeconomic or financial shocks which could affect the financial condition of such institutions, and sets out contingent strategies for handling future financial sector weaknesses based on portfolio composition, market risks, and macroeconomic developments which vulnerable institutions are exposed to.	***(c) through MoF has issued Decree Number 1450, dated May 29, 2003, ordering the assumption of residual debts of IFI.***	permit the provision of credit to an increased number of productive enterprises with cash flow prospects. 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

PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL	RESULTS / OUTPUTS TO-DATE	PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL	EXPECTED OUTCOMES FROM THE PROGRAM
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.	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. 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.	The FOGAFIN administered inflation hedge for mortgage borrowers, was implemented with 15,000 subscribers covering loans up to US$135 million equivalent. Thirty issues of mortgage backed securities were completed in 2003 for a total of US$ 700 million equivalent. In June 2004, the first issue of non performing asset backed securities (US$ 64 million) took place. A comprehensive assessment of the tax incentives affecting the overall housing finance sector has been completed by the MOF, including sequenced proposals to improve their consistency, efficiency and targeting, which will constitute elements of policy actions for future reforms. The MoF and the Central Bank restructure the FRECH swap hedge into an interest rate options product, after an agreement on the actuarial methodology and pricing parameters reached with the mortgage finance industry, and contracts are subscribed with mortgage banks to protect against interest rate risk. The FRECH liquidity fund to permit mortgage securities access to repo markets is fully approved and operational.	The Borrower: (a) through MoF has issued Decree Number 2481, dated September 2, 2003, authorizing FINDETER to onlend funds to banks and finance companies operating in the Borrower's territory to enable them to finance micro housing loans, (b) through FINDETER has issued Acuerdo Number 001, dated February 10, 2004, implementing a rediscounting program for said banks and finance companies to enable them to offer mortgage and real estate micro-credits to lower income communities, (c) through MAVDT has signed an agreement with the banking industry establishing a voluntary program to offer credit to the Borrower's micro-housing finance sector and to fund FINDETER bonds for deployment in the same program, and (d) through FNG has issued Circular Externa Number 003, dated January 30, 2004, announcing the launch of a new insurance program based on actuarially based premiums, to cover finance companies operating in the Borrower's territory against losses from housing micro credits and social housing mortgage loans**.** ***(a) The Borrower, through MoF, has issued Decree Number 2061, dated June 24, 2004, setting forth risk-adjusted asset weights for the determination of capital adequacy under multi-tranche securitized instruments held by banks operating in the Borrower's territory; and (b) the Borrower, through MoF and SV, has issued Resolución Number 0690, dated August 12, 2004 setting forth the rules for capital allocations of securitization companies operating in the Borrower's territory***	Increased home ownership, especially in the underserved sectors is evident with consonant increases in family wealth and capital. Increased access to housing credit evidenced by underserved segments of the population. The production of mortgage loans has expanded and lending margins reduced. The micro housing finance market applied to housing has expanded including housing leasing contracts. 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. 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

PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL	RESULTS / OUTPUTS TO-DATE	PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL	EXPECTED OUTCOMES FROM THE PROGRAM
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.	Regulations on solvency margins and technical reserves for the insurance industry, by branch of business, have been drafted by the Insurance arm of the SB, and approved by the Bank Superintendent subject to the final review of the insurance industry and actuarial experts. The SB has provided a policy response on each core principle with respect to the evaluation report of insurance sector regulation and its adherence to core principles for supervision.	***The Borrower: (a) through MoF and SV has issued Resolución Number 0691, dated August 12, 2004, setting forth the value-at-risk methodologies and regulations for the mandatory reporting of market risks of investment portfolios of mutual funds subject to SV's supervision; (b) through SB has issued Circular Externa Number 031, dated August 9, 2004, setting forth value at risk methodologies and regulations for the mandatory reporting of market risks of investment portfolios of insurance companies, AFP's and trusts subject to SB's supervision; and (c) through SB has issued Circular Externa Number 013, dated March 19, 2004, to: (i) regulate the expansion of AFPs' investment limits in foreign securities with specified credit ratings; and (ii) limit the share of AFPs investments in related party institutions.***	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, lower costs, increased returns, reduction of liabilities for the State, and expansion of the client industry base.

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				
PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	**TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL**	**RESULTS / OUTPUTS TO-DATE**	**PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL**	**EXPECTED OUTCOMES FROM THE PROGRAM**
(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.	Twenty-eight public offerings of securities were made in 2003 for an amount of US$1.8 billion equivalent, an increase of 19% with respect to the previous year. Specific reporting requirements pertaining to both credit rating and market risk ratings, have been established for the mutual funds and collective investment scheme industries. Uniform asset valuation standards and methodologies have been established by regulation for private sector fixed income securities.	The Borrower, through MoF, has presented to its legislature a bill of law to inter alia amend Law 35-1993, including, inter alia: (a) new SV supervisory powers; (b) the procedures for the custody, settlement and payment systems of the Borrower's securities industry; (c) new qualifications for financial market intermediaries; (d) investor protection rules; and (e) corporate governance norms. The Borrower: (a) through MoF and SV has issued Resolución Number 513, dated August 6, 2003, regulating the operation and uniform prudential capital requirements for collective investment schemes operating in the Borrower's territory; (b) through SV has: (i) issued Resolución Number 584 dated September 5, 2003 specifying the methodology for the daily market valuation of mutual funds subject to SV's supervision; and (ii) issued Circular Externa Number 006 dated June 29, 2004, regulating public disclosure of information pertaining to credit ratings, market risks, commission bases, and returns calculation methodologies for the Borrower's mutual funds industry.	The new capital market provides efficient and lower cost alternatives to credit intermediation, thus improving domestic investment, business productivity and enterprise growth. 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: DGCPT, SV, BRC

PRIOR ACTIONS UNDER THE FIRST PROGRAMMATIC FSAL	TRIGGERS FOR THE SECOND PROGRAMMATIC FSAL	RESULTS / OUTPUTS TO-DATE	PRIOR ACTIONS UNDER THE SECOND PROGRAMMATIC FSAL	EXPECTED OUTCOMES FROM THE PROGRAM
(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 program of weekly issuance of 90 days T-bills has been implemented with issuance authorization expanded from COP 5 billion (US$ 1.9 mn. equivalent) in January 2003 to COP 80 billion (US$ 31 mn equivalent). 90 day T-bills issued in 2003 amounted to US$ 238 mn. and 180 day T-bills were US$ 34 mn. In 2004 through July, 90 day T-bill issuance was US$ 661 mn. Provisions legislating legal finality for repurchase, short term collateralized loan instruments and securities swap transactions, have been incorporated in the new Securities Law presented to Congress.	*The Borrower, through MoF, has: (a) issued Resolución Number 921, dated April 14, 2004, to establish a public debt policy committee and setting forth it's precise functions and responsibilities; and (b) implemented a strategy to expand the issuance of 90 day treasury-bills, including a short term public securities zero risk yield curve based on increased liquidity and secondary market price formation in the short end of the market.*	The government debt program generates increased competitiveness and pricing transparency in the private bond, notes, and commercial paper market. 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.