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Colombia: Financial System Stability Assessment Update, including Reports on the Observance of Standards and Codes on the following topics: Securities Regulation, Insolvency and Creditor Rights Systems, and Payment Systems; and Comments by Authorities

This Update to the Financial System Stability Assessment (FSSA) on Colombia was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on April 5, 2005**.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Colombia or the Executive Board of the IMF. Also attached are comments by the Colombian authorities, dated May 16, 2005.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

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COLOMBIA

Financial System Stability Assessment Update

Prepared by Monetary and Financial Systems and Western Hemisphere Departments

Approved by Stefan Ingves and Anoop Singh

April 5, 2005

A joint IMF-World Bank mission visited Bogotá from September 27 to October 8, 2004 to conduct an update of the 1999 Financial Sector Assessment Program (FSAP). The mission met with the Vice Minister of Finance, Superintendent of Banks and Insurance, Superintendent of Companies, Superintendent of the Securities Market, Director of FOGAFIN, and national regulatory authorities for banks, insurance companies, and stockbrokers.

The FSAP team comprised Giovanni Majnoni (Mission chief, World Bank); Rodolfo Maino (Deputy mission chief, IMF); Craig W. Thorburn, Mario Guadamillas, Olivier P. Fremond, Michael Pomerleano, William Britt Gwinner, Alessandra Campanaro, Gustavo De Marco, Eduardo Urdapilleta (all World Bank); Roberto Garcia-Saltos, Pamela Madrid, Paloma Portela Peñas (consultant), and Julio Acevedo (consultant) (all IMF). In close coordination with the FSAP mission, Juan Dobson (consultant) conducted an assessment of *The Principles and Guidelines for Effective Insolvency and Creditor Rights Systems,* and Martin Naranjo (World Bank) conducted an update of recent developments of the Credit Risk Management System (SARC).

Overall, the financial sector appears relatively stable and resilient to potential adverse shocks. Since the 1999 FSAP, Colombia has recapitalized the banking system, improved financial legislation, and revamped the supervisory framework. However, the banking system still faces considerable challenges. The Superintendency of Banks lacks sufficient autonomy and independence, while the current legal framework fails to effectively protect either bank supervisors or the Superintendent. Risk-based regulation and consolidated supervision remain key issues going forward. In addition, solvency and profitability of commercial banks have improved, but provisioning for nonperforming loans remains low relative to international standards. The substitution of government bonds for private sector loans in bank balance sheets has shifted the balance from credit risk exposure into market and sovereign risk exposure. Notwithstanding a general revision and improvement of the legal and regulatory framework, weaknesses remain. The corporate insolvency regime introduced under emergency conditions during the crisis has not yet been replaced by new instruments more favorable to financial intermediation.

Annex 2 contains summaries of assessments under four standard and codes: the *IOSCO Principles;* the *CPSS Core Principles for Systemically Important Payment Systems;* the *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems;* and the main conclusions of an AML/CFT assessment conducted by the Financial Action Task Force of South America in October 2004.

The author of this report is Rodolfo Maino.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

Contents Page

MAIN ABBREVIATIONS AND ACRONYMS

AFP	*Administradora de Fondos de Pensiones* (Pension Fund Firm)
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BECH	*Bancos Especializados en Crédito Hipotecario* (Mortgage Banks)
BRC	*Banco de la República de Colombia* (Central Bank of Colombia)
CAR	Capital Adequacy Ratio (Regulatory Capital to Risk-Weighted Assets)
Col$	Colombian Pesos
CPSS	Committee on Payments and Settlement Systems
FATF	Financial Action Task Force
FOGAFIN	*Fondo de Garantías de Instituciones Financieras* (Deposit Insurance Fund)
FSAP	Financial Sector Assessment Program
FSI	Financial Sector Indicators
GAFISUD	*Grupo de Acción Financiera de Sudamérica*
IOSCO	International Organization of Securities Commissions
NPL	Nonperforming Loans
SARC	*Sistema de Administración Riesgos de Crédito* (Credit Risk Management System)
SBC	*Superintendencia Bancaria de Colombia* (Superintendency of Banks)
SSC	*Superintendencia de Sociedades de Colombia* (Superintendency of Companies)
SVC	*Superintendencia de Valores de Colombia* (Securities Superintendency)
TES	Treasury Securities
UVR	*Unidad de Valor Real* (Index based on real value of mortgages)

I. Summary and Overall Stability Assessment

1. **Prudent macroeconomic policies, structural reforms, and a favorable external environment have permitted the economy to recover gradually but steadily from the 1999 crisis.** Building on a successful bank recapitalization scheme and on the improvement of the supervisory framework, the Colombian financial system appears reasonably sound and stable. However, the banking system still faces considerable challenges. Solvency and profitability of commercial banks have improved, but specific provisioning of higher risk loans still appear low relative to better provisioned banking systems, suggesting that additional provisioning costs may keep interest rate spreads high or reduce bank profitability in the future. Bank capital adequacy may also be overstated by some overvaluation of foreclosed assets and underestimation of market risk. Notwithstanding the improvement of their performance, and the diversification of their activities, mortgage banks (BECHs) remain weak.

2. **The replacement of private sector loans with government bonds in bank balance sheets has altered the nature of the risks confronting the banking sector and represents a lingering legacy of the crisis.** The government response to the crisis and the lower demand for credit, as elsewhere in Latin America, have increasingly transformed credit risk exposure into a market risk or sovereign credit risk exposure.

3. **Notwithstanding a general revision and improvement of the legal and regulatory framework, weaknesses remain.** The Superintendency of Banks lacks sufficient autonomy and independence, and the current legal framework fails to effectively protect either bank supervisors or the Superintendent. The revision of the banking law has improved solvency requirements, while also creating a framework conducive to more effective supervision. At the same time, regulatory forbearance has not been completely eliminated as indicated by the low level of provisioned nonperforming loans and by the sensitivity of solvency ratios to conservative criteria of asset evaluation. Some of the funds lent for bank recapitalization have been prepaid and the prospects for repayment of remaining Deposit Insurance Fund (FOGAFIN) credits appear favorable as most recapitalized banks have regained market access or are backed by prominent financial holding companies. However, the two largest institutions are still under FOGAFIN control.

4. **Credit risk and interest rate risk are the main vulnerabilities, given the magnitude of exposures, relative sensitivities, and volatility of risk factors.** The impact of the greatest interest rate shock on capital would come from a precipitous rise in the yield curve. Foreign exchange risk appears limited, while equity price risk affects mostly finance corporations.

5. **The corporate insolvency regime introduced under emergency conditions during the 1999 crisis (Law 550) has not yet been replaced by new instruments more favorable to financial intermediation.** Credit to the private sector would benefit from the revision of the legal framework for reorganization procedures as bank credit is impeded by the excessive protection of debtors against creditors in restructuring procedures, provided by Law 550.

6. **Distortionary taxation on financial transactions and on medium- and long-term bank loans needs to be removed.** The financial transactions tax has compromised the

efficiency of the payment system, reduced the volume of financial transactions, and encouraged business to migrate to the underground economy. The 1.5 percentage point stamp tax on bank loans provides a disincentive to long-term lending that has increased with declining nominal interest rates.

7. **Mortgage lending has not recovered and housing financing appears to rely largely on either the repatriation of foreign assets or on informal markets.** Sluggish mortgage lending limits a potentially important generator of economic growth, and a source of long-term investments for pension funds and insurers in the form of mortgage-backed securities. The government should develop a comprehensive strategy for housing finance, including a restructure of the current tax subsidies for mortgage lending.

8. **The technical and organizational challenges for the full implementation of the new risk-based approach to bank provisioning requirements remain substantial.** The pioneering work of the Superintendency of Banks in the risk-based definition of loan-loss reserve requirements has required substantial investment in human resources and a redefinition of traditional supervisory approaches. Following up this work, the Superintendency of Banks needs to prepare a road map or strategy, in consultation with the banking system, for the full implementation of the new system of credit management, as well as making explicit the alternatives for those banks that may not opt for internal models. Also, a clear definition of the scope of consolidation needs to be established as a precondition for risk-based supervision.

9. **To achieve long-term sustainability of pension reform, several changes are required.** The 1993 pension reform has generated a rapid increase in pension fund assets and will, over a few years, produce a growing volume of annuities issued by life insurers. However, costs of intermediation need to be substantially reduced by streamlining collection procedures and record-keeping, and by revising marketing regulations. In addition, costs of transition in the pay-as-you-go pillar need to be reduced by increasing the retirement age and vesting periods, and reducing accrual rates.

10. **Although private capital markets have developed fairly well since the last FSAP, they continue to be characterized by low liquidity and insufficient depth, attributable to the scarce supply of investment securities by local corporations, and deficiencies in clearance and settlement systems.** In particular, most resources are channeled through the banking sector, while capital markets have not yet become an alternative financing source for the private sector. In this context, the modernization of the securities markets regulatory framework is critical to increase liquidity, and stimulate investment.

11. **The adoption of norms of corporate governance increasingly oriented to reward efficient management of resources is strongly recommended.** The modest level of profitability of the corporate sector remains a source of concern for the stability of the banking system, leaving the sector highly exposed to volatility in economic activity. The strong dependence of banks' NPLs on cyclical downturns confirms the high sensitivity of corporate performance to adverse cyclical conditions in spite of a very modest degree of leverage. Similarly, progress in accounting and auditing practices has become a policy priority aimed at a more stable flow of credit toward more profitable areas of business.

12. **The main recommendations of the FSAP update (Box 1) require different implementation timeframes.** In this regard, recommendations have been split between those that can be implemented within a two-year horizon and those that, due to complex approval procedures, may require longer time horizons. The first category includes those measures aimed at strengthening supervisory capacity, solving the remaining problems left by the 1999 crisis, or addressing impending problems. The second category includes reforms aimed at making financial supervisors more independent, reforming accounting standards and the auditing profession, and strengthening consolidated and risk-based supervision, among others.

II. Macroeconomic Context

13. **Colombia has benefited from a long tradition of macroeconomic stability, despite the severity and economic costs caused by political violence.** For the last 35 years Colombia's volatility of growth and inflation has been one of the lowest in Latin America. Real GDP grew by only 1 percent on average from 1996 to 2001, with increased volatility, and unemployment rose to record levels of 20 percent at the end of 2001. Fiscal imbalances widened sharply with rising pension costs, while the financial system and the foreign exchange market came under stress in 1999. The combined public sector deficit grew between 1996 and 1999 from 3 to 5.5 percent of GDP and stayed above 3 percent from 2000 to2002. Public sector debt rose from about 45 percent of GDP in 2000 to 56 percent of GDP in 2003 (Table 1).

14. **Since 2002, the government has sought to reverse these deteriorating trends with more prudent macroeconomic policies and structural reforms.** On the fiscal front, the government introduced expenditure cuts, imposed a one-time wealth tax under emergency legislation, passed a broader tax package, and set in motion a structural fiscal reform program, including pension reform. The key focus of the reform program has been to reduce public debt. The medium-term fiscal strategy calls for increasing the primary surplus to 3 percent of GDP, consistent with reducing public debt to below 45 percent of GDP by 2010. Against the background of the recent peso appreciation, monetary policy is cast in a framework of inflation targeting and a floating exchange rate.

15. **Economic prospects remain positive and fiscal policy is beginning to ease the burden of public debt.** GDP growth is expected to remain at 4 percent also in 2005. The combined public sector deficit for 2004 was 1.2 percent of GDP (down from 3.6 percent in 2002), with the primary surplus reaching 3.0 percent of GDP (from 0.4 percent in 2002). Total public debt declined to 54.1 percent of GDP in 2004 from 60.2 percent in 2002.

Box 1. Colombia: FSAP Update Main Recommendations

A. Strengthening bank regulation and supervision by the SBC	
• Provide the SBC with more autonomy and regulatory power.	MT
• Have the SBC prioritize the SARC project.	ST
• Ensure that the SBC moves toward full implementation of consolidated supervision.	MT
• Have the SBC adapt its internal organization and resources to accomplish the above challenges.	ST
B. Bringing to an end the crisis resolution-phase	
• Government should devise a comprehensive plan to privatize Bancafe and Granahorrar.	ST
C. Strengthening insurance regulation and supervision	
• Improve bank regulation, supervisory practices, and market infrastructure to cope with annuity market development.	ST
• Strengthen risk-oriented solvency and provisioning regulation in the nonlife sector.	MT
• Strengthen the independence of the regulatory function of the supervisory agency.	MT
• Provide adequate resources for insurance and pension supervision.	ST
D. Strengthening pension funds regulation and supervision	
• Eliminate fragmentation and privileges in the pension system.	MT
• Revision of the parameters of the "pay-as-you-go" scheme to insure long-term sustainability.	ST
• Constitute a task force to address the problem of contributive evasion.	ST
• Shift from prescriptive to risk-based approaches to pension regulation and supervision.	MT
• Coordinate the programs of different supervision agencies.	ST
E. Improve capital markets regulatory framework	
• Strengthen the regulatory regime by implementing the new Securities Market Law.	ST
• Take measures to harmonize responsibilities, avoiding the current regulatory and supervisory overlap.	ST
• Adopt international auditing and accounting standards.	MT
• Ensure that *Securities Superintendency* (SVC) should have sufficient resources for supervision, enforcement, and securities settlement.	ST
• Promote local and international cooperation to share information.	ST
F. Developing the payment systems	
• Strengthen the supervisory framework for payment systems by BRC (*Banco de la República de Colombia*).	MT
• Eliminate the financial transactions tax.	ST
G. Reducing corporate sector vulnerabilities	
• Improve auditing standards and professional standards.	MT
• Improve the dissemination of corporate data information.	ST
• Enhance quality of analysts, insolvency experts, and appraisers.	MT
• Revise Law 550 on insolvency procedures.	ST

ST = recommendations that can be implemented in less than two years.
MT= recommendations that may take more than two years to implement, due to required legal or constitutional reforms.

Table 1. Colombia: Selected Economic and Financial Indicators

	2000	2001	2002	2003	2004 Rev.	2004 Prel.	Proj. 2005	Proj. 2006
	(Percentage changes, unless otherwise indicated)							
National income and prices								
Real GDP	2.9	1.5	1.9	3.8	4.0	3.8	4.0	4.0
GDP deflator	12.1	6.2	6.5	7.2	5.9	5.5	4.3	5.1
Consumer prices (average)	9.2	8.0	6.3	7.1	6.0	5.9	5.2	4.8
Consumer prices (end of period)	8.7	7.6	7.0	6.5	5.5	5.5	5.0	4.5
External sector (on the basis of US$)								
Exports (f.o.b.)	14.0	-6.4	-4.1	11.2	11.2	23.6	-0.1	3.2
Imports (f.o.b.)	8.1	10.6	-1.6	9.8	15.1	19.9	15.7	2.7
Export volume	1.1	0.9	-4.4	2.6	2.9	6.7	0.7	6.5
Import volume	10.0	10.5	-1.6	5.2	7.6	13.3	16.9	2.5
Terms of trade (deterioration -)	14.8	-7.3	0.3	3.9	1.1	9.3	0.2	-3.3
Real effective exchange rate (depreciation -)	-2.6	1.5	-17.4	-5.2	…	11.4	…	…
Central administration								
Revenue	25.7	20.8	10.1	13.9	15.4	16.0	9.3	9.1
Expenditure	11.9	16.7	12.6	6.8	10.7	15.7	11.5	10.2
Money and credit 1/								
Broad money	1.5	6.4	5.3	6.5	10.2	16.7	11.1	10.3
Credit to the private sector	-8.6	1.7	4.0	9.2	11.5	12.2	14.6	14.0
Interest rate (90-day time deposits; percent per year)								
Nominal	13.4	11.5	7.7	7.9	…	7.7	…	…
Real	4.2	3.6	0.7	1.4	…	2.2	…	…
	(In percent of GDP)							
Central administration balance	**-5.7**	**-5.7**	**-6.5**	**-5.3**	**-5.6**	**-5.6**	**-6.1**	**-6.3**
Nonfinancial public sector balance	-3.5	-3.5	-4.2	-3.1	-2.8	-1.6	-2.4	-2.1
NFPS primary balance	**0.9**	**1.3**	**0.4**	**1.7**	**2.2**	**3.0**	**2.7**	**2.7**
Public sector balance	**-3.4**	**-3.2**	**-3.6**	**-2.7**	**-2.8**	**-1.2**	**-2.5**	**-2.0**
Foreign financing	1.6	2.3	0.6	1.0	1.7	-0.4	0.8	0.5
Domestic financing 2/	1.2	0.9	3.1	1.8	0.8	1.7	1.8	1.5
Privatization	0.5	0.0	-0.1	-0.1	0.3	-0.1	-0.1	0.0
Public debt 3/4/	**47.7**	**51.8**	**60.2**	**56.6**	**52.1**	**54.1**	**51.2**	**49.5**
Gross domestic investment	13.7	14.5	14.2	15.1	15.5	14.3	15.8	17.0
Gross national savings	14.6	13.2	12.6	13.6	13.4	13.3	12.9	14.4
Current account (deficit -)	0.9	-1.4	-1.7	-1.5	-2.2	-1.1	-2.9	-2.6
External debt	46.1	47.5	52.3	46.4	43.7	38.1	37.2	37.2
Of which: public sector	26.3	28.5	31.9	29.9	28.6	24.7	23.6	23.2
NIR in percent of short-term debt	111.5	98.4	106.1	127.3	124.4	110.4	110.5	116.3
	(In percent of exports of goods, services, and income)							
External debt service	50.1	50.2	64.0	56.4	47.7	35.5	52.1	45.2
Of which: public sector	21.7	28.2	37.0	33.4	23.8	18.4	30.9	23.6
Interest payments	15.9	16.3	16.8	15.0	15.9	12.0	14.5	14.2
Of which: public sector	8.9	10.4	11.3	10.6	11.2	8.3	10.3	10.2
	(In millions of U.S. dollars)							
Overall balance of payments	870	1,217	138	-184	712	2,583	-855	313
Net official reserves 4/	8,800	9,982	10,507	10,524	11,408	13,195	12,340	12,653
Net official reserves (in months of imports of goods and services)	6.8	8.0	7.9	7.7	7.2	8.1	6.7	6.7

Sources: Colombian authorities; and Fund staff estimates and projections.

1/ All annual changes in foreign currency stocks valued at constant exchange rate.
2/ Includes the quasi-fiscal balance of Banco de la Republica, sales of assets, phone licenses, and statistical discrepancy.
3/ Includes bonds issued to recapitalize financial institutions.
4/ Program definition. Assumes no purchases under the current SBA arrangement. Includes valuation changes.

16. **The favorable economic outlook has opened a window of opportunity for further financial sector reforms, but macroeconomic vulnerabilities remain.** Rising international interest rates may significantly affect the gains in fiscal consolidation and deteriorate the balance sheets of financial institutions. Any relaxation of fiscal discipline may jeopardize business confidence and compromise long-term growth. Steady increases in net pension costs will complicate expenditure management, unless pension reform is adopted soon to ease this burden. Also, the tenuous security situation might affect investment prospects and long-term growth. Finally, a weakening of the inflation targeting approach could compromise progress in reducing inflation. So far, greater exchange rate flexibility has played a key role in improving external sector performance and has increased the ability of the financial sector to assess foreign exchange risks and to withstand shocks.

III. Vulnerabilities and Development Opportunities in the Financial Sector[1]

A. Update of Banking Sector Developments

17. **The financial soundness of the banking sector deteriorated abruptly during the period 1998–1999 as adverse macroeconomic factors triggered the end of a credit boom, which coincided with poor credit management and weak bank regulation and supervision.** A credit boom, particularly for housing during the early 1990s, fed an asset price bubble and debt burdens, while bank provisioning rates remained substantially below prudent levels. By mid-1998, declining economic activity, real depreciation, a spike in (already high) real interest rates, and falling asset prices led to increased nonperforming assets and reduced the liquidity, profitability, and solvency of many institutions.

18. **The authorities responded with emergency support measures and reforms in regulation and supervision.** From 1999 to 2001, the government introduced a mortgage debtor relief program as well as incentives for corporate debt restructuring and for recapitalization of banks. Prudential regulations were tightened to increase provisioning and capital adequacy, including a general provisioning requirement of 1 percent of total loans as well as capital requirements for market risk. Since the crisis, an intense consolidation has taken place, enhancing market share for larger banks (Table 2). Furthermore, following the crisis, loan portfolios declined in real terms and banks increasingly invested in government securities between 1998 and 2002. Total bank loans decreased around 30 percent in real terms between 1998 and 2003, mostly due to the contraction in mortgage loans, which declined close to 60 percent. This reflected loan write-offs, stricter provisioning rules, and private sector balance sheet restructuring. The dramatic decline in mortgage loans resulted in greater exposure to commercial and consumer loans.

[1] The banking system comprises banks (including those specialized in housing finance, BECHs), finance corporations, commercial finance and leasing companies, and cooperatives of superior grade.

Table 2. Colombia: Financial System Structure by Asset Holding and Numbers of Intermediaries

	Dec-2000					Dec-2003				
	No.	CO$ billions	US $ MM	% of total assets	% of GDP 2/	No.	CO$ billions	US $ MM	% of total assets	% of GDP 2/
Commercial Banks	**24**	**47,527**	**21,320**	**42.9**	**27.2**	**22**	**62,322**	**22,432**	**45.0**	**27.5**
Domestic	13	33,093	14,845	29.9	18.9	13	46,954	16,901	33.9	20.7
Private	10	23,576	10,576	21.3	13.5	10	35,361	12,728	25.5	15.6
State-Owned 1/	3	9,517	4,269	8.6	5.4	3	11,593	4,173	8.4	5.1
Foreign	11	14,434	6,475	13.0	8.3	9	15,368	5,532	11.1	6.8
Banks specialized in housing (BECHs)	**6**	**20,226**	**9,073**	**18.3**	**11.6**	**6**	**22,558**	**8,120**	**16.3**	**10.0**
Quasi-banks 3/	**14**	**849**	**381**	**76.6**	**48.5**	**7**	**433**	**156**	**31.3**	**19.1**
of which: Coop. Superior Grade (OCGS)	1	58	26	0.1	0.0	1	58	21	0.0	0.0
Other lending institutions	**40**	**12,578**	**5,643**	**11.4**	**7.2**	**30**	**12,367**	**4,451**	**8.9**	**5.5**
Finance Corporations	8	9,176	4,116	8.3	5.2	4	7,118	2,562	5.1	3.1
Financing Companies	32	3,403	1,526	3.1	1.9	26	5,249	1,889	3.8	2.3
Traditional	18	1,411	633	1.3	0.8	15	1,890	680	1.4	0.8
Leasing	14	1,992	894	1.8	1.1	11	3,359	1,209	2.4	1.5
Institutional Investors	**65**	**20,404**	**9,153**	**18.4**	**11.7**	**60**	**33,617**	**12,100**	**24.3**	**14.9**
Insurance	53	6,165	2,766	5.6	3.5	48	10,168	3,660	7.3	4.5
Mutual funds Mgmt. C.		1,033	463	0.9	4.6		1,717	618	1.2	0.8
ISS	1	5,216	2,340	4.7	3.0	1	1,378	496	1.0	0.6
AFP´s	6	7,990	3,584	7.2	4.6	6	20,354	7,326	14.7	9.0
Financial System Total Assets	**144**	**110,761**	**49,687**	**100.0**	**63.3**	**120**	**138,416**	**49,822**	**100.0**	**61.2**
Memorandum item										
Total Tier II Public Banks	9	17,835	8,001	16.1	10.2	9	20,522	7,387	14.8	9.1

Source: Superintendencia Bancaria
1/ Only tier 1 banks.
2/ Values of GDP in current billion US$ were $78.5 in 2000; and $81.5 in 2003.
3/ Cooperatives and mutual banks.

19. **Aided by the authorities' policy response and improved macroeconomic conditions, the financial system has strengthened since the crisis.** The risk-weighted capital adequacy ratio (CAR) for the system stood at 14 percent as of September 2004, versus less than 11 percent before the crisis, and all institutions had a CAR above the 9 percent minimum. Classified loans (substandard, doubtful or loss) stood at 7.9 percent as of September 2004, down from 16.3 percent at the end of 1998 (Table 3). Furthermore, the ratio of loan loss provisions to classified loans has grown from 25 to 54 percent since 1999. The reduction in high-risk loans and increased provision coverage indicate that banks are now less exposed to credit risk in the banking book.[2] Return on average assets has reached an annualized 2.7 percent as of September 2004, versus -3.5 percent in 1999. Liquidity for banks, as measured by the three-month liquidity gap, has improved from -120 percent of liquid assets in

[2] The current loan classification has five categories (A–E), with loans C–E considered higher risk ones (e.g., substandard, doubtful, and loss) and was introduced in 1999.

July 1999 to under -30 percent of liquid assets as of June 2004.[3] The other side of this strengthening is that capital, earnings, and liquidity are now more exposed to long-term fixed-rate treasury securities, making banks more vulnerable to sovereign credit deterioration or to an increase in interest rates. An estimate of recent valuation gains from government securities shows that excluding these gains, other operational income still exceeds operational and provisioning expenses, but a reversal of the recent trend of interest rate reductions could lead to valuation losses and pressure profitability.[4]

20. **Despite the recent improvements in financial sector indicators, potential underestimation of provisioning and capital requirements is still of concern and the authorities are working to further increase both elements.** Although provisioning rates have improved dramatically since the 1999 crisis, specific provisioning of higher risk loans still appears low relative to better provisioned banking systems. Also, prudential rules on market risks may underestimate capital requirements for these risks. The authorities are working to close these provisioning and capital gaps. In particular, starting in July 2005, financial institutions will be required to hold provisions in line with estimated expected credit losses of their commercial and industrial loans. Banks will be given the option of adopting a supervisory model for computing expected losses or asking for the validation of their own internal models for the measurement of expected credit losses. The calculation of market risk capital requirements has improved; however, current rules still allow some netting of UVR (real value of mortgages), and peso-denominated positions, which may underestimate the value-at-risk.[5]

21. **Adjustments to estimate the impact of tightening prudential rules indicate that it would be prudent for some institutions to increase provisioning and capital given current risk exposures.** The institutions most sensitive to these adjustments are BECHs, followed by finance corporations and public banks. Private banks, notwithstanding their lower sensitivity to the adjustments, could also fall below the regulatory minimum owing to their lower initial capital base. Most of the adjustment is for potential underestimation of capital requirements for market risk and underprovisioning for expected credit losses. The Colombian authorities have already tightened some aspects of market risk capital requirements and have put in place tightening of provisioning for loans and foreclosed assets by end-2005. These tightening of

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[3] The gap ratio is calculated as the ratio of the cumulative three-month gap, excluding liquid assets to three months, to total liquid assets (defined as cash, interbank deposits and repos, and negotiable debt securities).

[4] Based on the proportion of government debt securities in the securities portfolio, the core operational income (i.e., excluding valuation gains on government securities) to gross income was estimated as 82 percent versus the ratio of operating plus provisioning expenses to gross income of 63 percent.

[5] It should be noted that most countries do not require capital against interest rate risk on loans held in the banking books as Colombia does.

Table 3. Colombia: Banking System Financial Soundness Indicators 1/

(In percent)

	1998	1999	2000	2001	2002	2003	2004 2/
Capital adequacy ratio (with market risk) 3/	n.a.	11.3	13.2	13.0	12.6	13.1	14.0
Regulatory Tier I capital to risk weighted assets	n.a.	8.0	9.2	9.3	9.7	10.5	11.4
Capital to assets	10.6	11.0	11.3	11.2	11.0	11.5	11.9
Nonperforming loans net of provisions to capital	27.2	35.9	15.6	5.6	1.1	-3.8	-10.5
Nonperforming loans to total loans 4/ 5/	9.1	12.4	10.6	10.2	9.2	6.8	3.6
Classified loans 5/	n.a.	18.1	18.7	18.1	16.0	12.1	7.9
Specific provisions to classified loans and leases	n.a.	25.3	27.7	37.5	43.0	47.6	54.0
Sectoral distribution of loans to total loans 5/							
commercial	53.0	55.2	58.7	58.4	61.9	62.8	65.8
consumer	17.9	13.4	14.1	15.6	15.6	18.0	19.1
housing	29.1	31.4	27.2	26.0	21.7	18.1	14.1
Foreign currency loans to total loans	11.9	9.0	8.1	7.0	7.4	4.7	5.2
Return on average equity	...	-32.6	-20.7	1.1	9.6	17.0	23.4
Return on average assets	...	-3.5	-2.3	0.1	1.1	1.9	2.7
Interest margin to gross income	41.0	30.7	38.1	32.7	35.5	37.4	39.5
Noninterest expenses to gross income	83.5	95.4	93.7	85.6	80.7	69.8	59.8
Personnel expenses to noninterest income	43.0	38.6	36.2	37.3	38.3	38.4	41.5
Liquid assets to total assets 6/	10.0	11.9	12.9	16.5	19.7	18.7	18.0
Liquid assets to short-term liabilities 7/	17.3	19.2	20.4	25.2	30.2	29.0	28.1
Customer deposits to total (noninterbank) loans	93.8	107.5	122.3	136.1	136.1	136.0	126.2
Spread between reference lending and deposit rates	9.7	4.4	6.6	8.3	7.4	7.4	7.3
Foreign currency liabilities to total liabilities	12.1	9.4	9.1	8.6	7.0	6.2	6.0
Net open position in foreign exchange to capital	5.1	-0.1	-1.4	4.8	7.8	4.3	4.8

Sources: Superintendencia Bancaria; IFS; and Fund staff estimates.

1/ Excluding credit unions and public sector special institutions (IOE).
2/ Data to Sept. 2004 except data on foreign currency loans and liabilties, which are to June 2004. Returns are annualized as necessary.
3/ Market risks requirements, effective only as of 2001, are weighted 60% until 2003, 80% in 2003, and 100% thereafter.
4/ Loans past-due 90 days or more (120 days or more in the case of mortgages)
5/ Loan data includes leases as of 2004.
6/ Liquid assets include cash, deposits in other financial institutions and interbank repos, and securities held for trading.
7/ Customer deposits used as proxy for short-term liabilities.

prudential requirements will maintain pressures on banks' provisioning and capital levels and most likely would limit any possible further compression on interest rate spreads.

22. **In addition, banks appear vulnerable to rollover risk.** Half of the banks have a negative one-month maturity gap (liabilities liquidating within one month exceed assets liquidating within one month). Furthermore, there is a systemic and structural gap at three months. Thus, in the case of a systemic liquidity shock, banks could incur losses in liquidating part of their negotiable securities given the size of their potential exposures and the fact that most banks would be on the same side of the market.

B. Stress Tests

23. **Credit risk and interest rate risk are the main vulnerabilities, given the magnitude of exposures, relative sensitivities, and volatility of risk factors.** A regression analysis of credit quality and macroeconomic factors showed NPLs to be most sensitive to GDP growth. Based on estimated elasticities and given a shock to GDP of -3 percent (equal to about 1 standard deviation), past dues were estimated to increase by 14 percent of total loans.[6] For the aggregate of credit institutions, the CAR would fall from 13.7 to 8.6 percent.

24. **The impact of the greatest interest rate shock on capital would likely come from a very large steepening of the yield curve**. The effect of interest rate shocks has been calculated as the joint effect of the losses from asset valuation changes and from higher capital requirements. Several changes in the yield curve have been simulated and credit institutions appeared most exposed to the risk of a steepening yield curve. These tests include the entire banking book, which is not marked-to-market, and thus the total simulated impact on capital is unlikely to materialize in the short-term, at least in an accounting sense. In particular, the aggregate CAR level after a steepening of the curve would fall to 6.8 percent.

25. **Foreign exchange risk appears limited, while equity price risk mostly affects finance corporations.** There is very little direct loss impact of a depreciation, because most banks are long in U.S. dollars. Indirect risk, through corporate sector exposures, also appears to be limited given the estimated low elasticity of NPLs to the real exchange rate and the relatively low percentage of loans in foreign currency. A moderate shock to equity markets would not severely affect commercial banks but could impact finance corporations. Furthermore, liquidity risk stress tests indicate that private banks, in particular, are vulnerable to withdrawal of uninsured deposits, underscoring the need to maintain confidence and liquidity in the system. Uninsured savings and current account deposits, those above Col$ 20 million, which are likely to be withdrawn if there is uncertainty about bank or macroeconomic stability, account for 67 percent of total deposits, and represent close to 80 percent of the deposit base of private banks.

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[6] These estimates are based on a model developed jointly by the Colombian authorities and the World Bank.

26. **Financial institutions and supervisory authorities need to place more systematic emphasis on stress testing.** The Colombian financial sector enjoys high-quality technical capability. However, resources have recently been devoted to the SARC and little systematic attention has been paid to stress testing.[7] At the Superintendency of Banks (SBC), resources are also stretched. Efforts could be made to create a stress testing committee that leverages the expertise across the public sector, e.g., the central bank could supply macro scenarios and the SBC could assess the impact on individual institutions and aggregate results.

C. Bank Regulation and Supervision Update

27. **The quality of bank supervision and regulation has improved since the 1999 FSAP as indicated by progress in Basel Core Principles implementation.**[8] Areas where progress has been either modest or nonexistent include on- and off-site supervision (the SBC is still working on a draft project to introduce improvements), control of other material risks (operational, procedural) and of banks' internal control procedures.

28. **The SBC lacks sufficient autonomy and independence, and the current legal framework fails to effectively protect either bank supervisors or the Superintendent.** The SBC is subject to current government-wide fiscal restraints, although its resources are provided by direct levies on banks and exceed the SBC expenditures. In addition, the profile, terms of appointment and removal of the Superintendent are areas that have not been clarified since the 1999 FSAP. In addition, the fact that norms related to the banking sector are issued by the Ministry of Hacienda and not by the SBC represents a *de facto* subordination of the SBC and a potential source of conflicts of interest.[9] Previous efforts to increase the autonomy of the SBC through legal changes have met with congressional opposition.

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[7] A survey by authorities revealed that financial institutions are only allocating about US$0.1 million on risk aggregation and stress testing versus US$1 million on credit risk (SARC).

[8] Significant revisions of the legal framework were undertaken in the period 1999–2003 with a number of modifications of the Banking Law (Law 510 in 1999, Decree 1720, in 2001 and Law 795 in 2003) which raised minimum bank capital requirements for credit and market risk, in addition to providing the legal background for the early warning system, prompt corrective actions, and consolidated supervision. The Banking Law also sought to protect consumers and to diversify the supply of bank products (Article 7). In addition, the SBC issued regulations to define a new system of risk-based loan classification and provisions, encompassing specific and general provisioning requirements.

[9] The definition of nonzero risk weights on banks' holdings of government debt for capital requirement purposes—in line with Basel II—is an area where conflicting views may emerge.

29. **Since 1999, the SBC has improved prudential regulations in two main areas, market and credit risk.** Capital requirements for market risk were introduced in December 2001 concomitantly with a new loan classification and provisioning system (SARC). The SARC constitutes a pioneering effort to apply risk-based regulation to the definition of loan loss reserves. As such, it extends to loan loss reserves the principles behind risk-based capital regulation developed by the Basel Committee. No progress has been made in regulating country risk. Risk-based regulation and consolidated supervision remain key issues going forward.

30. **An internal administrative reorganization of the SBC is needed.** Conduct of supervision at the SBC is based on units that follow individual supervised entities and are not necessarily well-trained in risk management. Qualified staff may also be insufficient should an important number of banks decide to migrate to internal models. Nevertheless, risk-based supervision requires innovations in the supervisory approach and organization. Validation and supervision of databases, systems, models, methodologies and consistency of the results are major challenges for the SBC.

31. **The SBC should issue norms concerning the role, duties, and responsibilities of external auditors (*revisores fiscales*).** In particular, the lack of audit standards and the lack of alignment with International Accounting Standards represents a serious departure from international best practices for financial reporting and transparency. In addition, the requirements that the SBC validate bank financial statements generates a confusion of roles and responsibilities between the SBC and the auditors that needs to be addressed.

32. **Since 1999, important progress has been made to facilitate consolidated supervision of financial conglomerates, but a comprehensive vision of how the risks assumed by groups may affect banks' soundness needs to be defined.** The establishment of capital adequacy rules, the definition of limited accounting regulations and disclosure requirements, and the empowering of SBC to access related company information are steps in the right direction.

33. **There is a need for better coordination of efforts and information among the SBC, the Securities Superintendency (SVC), and the Superintendency of Companies (SSC).** Colombia already enjoys a concentration of the supervisory responsibility over banks, insurance and pension funds in the SBC. Rules for cooperation should entail specific requirements for exchange of information, consultation and assistance on policy, monitoring of markets and entities, and conflict resolution processes. The SVC and the SBC should harmonize regulation and supervisory practices for independent brokers and bank-related brokers to assure a level playing field. The agencies should define a "lead supervisor" with clear responsibility and accountability concerning market, credit and liquidity risks, and stress tests.

34. **The SBC lacks the capacity to adequately examine the relationship between local banks and their foreign branches.** The degree and nature of local banks' exposure to risk assumed by their overseas branches are not currently known by the SBC, making it more difficult to protect local banks.

D. Mortgage and Public Banks

35. **The mortgage and public banks, which were at the center of the 1999 crisis, have largely recovered.** Both groups were heavily recapitalized through several schemes. One mortgage bank has prepaid its recapitalization obligation to FOGAFIN, and the other three are expected to repay on schedule. The mortgage securitization conduit has brought six issues to market, and the central bank's hedging facility has been redesigned to more directly cover mismatch risk at a more attractive price. Public banks received Col$6.1 trillion in recapitalization lines during the crisis. Most of these resolved institutions have been liquidated or sold. From the three remaining public institutions, one will remain in the public domain as a development bank, while the other two are being privatized.

36. **Legal risk remains important for mortgage lenders.** Law 546 of 1999 imposed rigidities in mortgage design that negatively affected lower-income borrowers, by, for instance, outlawing floating rate peso loans. The government should develop a strategic housing policy aimed at reducing the housing deficit as an alternative to the constitutional court's interest rate ceilings. In addition, the government should restructure tax subsidies for mortgage lending to eliminate benefits to wealthy households, and to directly benefit low-income households in light of the existing constitutional court-imposed restrictions on Social Priority Housing lending.

37. **After the financial sector crisis, the authorities adopted a successful plan to divest or liquidate public banks.** The recapitalization process of public banks was complemented with the disposal of unproductive assets.[10] Remaining public banks enjoy a significant market presence with mixed results. Among them, Bancafé, Banco Agrario, and Granahorrar together represent around 14 percent of total assets of the banking system (commercial banks and BECHs).

38. **However, to date, the privatization effort of Bancafe has failed**. Labor costs are still much larger than those of peer banks. The labor liability, taking into account strong union presence in key areas, was the main reason of the failure of the February 2004 auction. In addition, given that existing market concentration limits effectively discourage the participation of large financial groups, it would be important to clarify the procedures to be followed in such cases.

39. **Granahorrar has also improved its financial position but the timing of privatization is unclear.** With a lower franchise value than Bancafe, the bank has a higher cost funding base, and high exposure to mortgage loans. On the other hand, Granahorrar does

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[10] In the aftermath of the crisis, 35 institutions were intervened and later on liquidated from 1998 to 2003, while 20 were voluntarily liquidated by their shareholders. Among the 14 institutions managed by FOGAFIN, 6 have been liquidated, 2 have been sold (the recent auction of *Banco Aliadas* earned 1.7 times book value), 2 have been merged, 2 are in an auction process, and 2 remain in the hands of FOGAFIN.

not have the labor liabilities of Bancafe. Still, given the problems revealed in the 2004 auction process and the lack of clarity about prospective bidders, its timing of privatization should be defined.

40. **Going forward, a comprehensive privatization strategy has to be redesigned in accordance with previous commitments.** A privatization plan for both banks taking into account their strengths and weaknesses should be redefined. Given the prior experience and results to date, this plan should address three main issues: (1) solve the union problem of Bancafe, by either finding an agreement with employees, taking the labor liabilities out of the bank, or liquidating it; (2) improve the marketability of Granahorrar, either as an ongoing concern valuable for prospective bidders or liquidating it; and (3) clarify rules regarding the definition of market power to reduce uncertainty to prospective bidders.

E. Nonbank Financial Institutions

41. **Since 1993, the pension system of Colombia has a funded scheme administered by private managers and a public "pay-as-you-go" (PAYG) scheme administered by a public institution, *Instituto de Seguridad Social*.** The shift of contributors to the private scheme, over a decade's time, has produced a rapid growth in private pension funds and depleted the reserves of the public PAYG scheme. In this regard, the long-term projections for the deficit of the public pillar of the pension system is of concern, and further reforms are needed, including increasing the retirement age and vesting period, as well as reducing the accrual rate in order to achieve long-term sustainability of the pension system.

42. **Six private companies (Pension Fund Firms or AFP) manage the funded pension scheme.** Out of these, the larger two concentrated more than 50 percent of the funds administered in August 2004. Net costs of administration represent almost 15 percent of contributions collected in August 2004, a percentage that is above the average of other Latin American countries with similar pension schemes. In this regard, there is a need to conduct a thorough analysis of the cost structure in the industry to identify the main components behind these results, including regulatory amendments, reforms in administrative procedures, and improving supervision of the system. One major problem of AFPs is their portfolio structure which has a strong predominance of public bonds and should be far more diversified.

43. **The mission recommended addressing the problem of high rates of evasion of payments to the system, both in the funded programs and at the PAYG.** Control of collection is decentralized and on an ex-post basis, based on claims of beneficiaries at the time of retirement. The government should promote the forming of a joint task force with representatives of the different agencies involved in collection to design and implement programs to control evasion based on the information produced by *Registro Unico de Aportantes*.

44. **The supervision model should gradually shift from a compliance-oriented to a risk-based approach.** Both the funded and the PAYG schemes are supervised by *Superintendencia Bancaria*. Centralized supervision of public and private schemes is rare in the international experience, and may have the advantage of allowing the supervisor to

influence the PAYG scheme. Centralized supervision may also help prevent possible effects of public mismanagement or permissiveness on the financial accounts of the pension system. However, it appears that current resources allocated to this function are insufficient to accomplish these objectives. In addition, the approach is traditional and compliance-oriented and needs to be gradually replaced by a risk-based one.

45. **The supervision of the PAYG scheme should coordinate with peer agencies.** *Instituto de Seguridad Social* is subject to the supervision of a multiplicity of agencies (*Contraloría de la Nación*, *Contaduría General*, *Procuraduría de la Nación*, and *Superintendencia Bancaria*), a fact that generates inefficiencies, and duplications of information.

46. **Concerning the insurance sector, the development of a complete regulatory structure for annuities should received immediate attention.** Premiums have shown healthy growth in real terms reflecting a steady progress in industry development over the medium term. Linkages of the life sector with annuities in the pension system will likely provide an opportunity for the life sector to make a substantive contribution to the wider capital markets. The nonlife sector, currently at levels consistent with peer countries, will probably play a more limited role in market development. Fixed income markets, particularly longer term instruments, will continue to be important to insurance companies offering annuities.

47. **Since the 1999 FSAP, insurance supervisors have improved technical skills and updated procedures consistent with emerging international best practices.** However, staff numbers diminished dramatically and have reached the point where constraints on available technical knowledge, experience, and skills are becoming a concern. The insurance team has advanced their technical work on internal risk-based financial assessment methods impressively. Movements toward a solvency-monitoring approach have been making steady progress. Some data collection initiatives in the nonlife sector are needed to take the analysis further along with targeted assistance on technical issues.

48. **The recently introduced law reflects international trends and good practices. A number of important areas, however, would benefit from further update, such as the formula for the solvency margin, rules for provisions, and distribution oversight.** The current rules, grandfathered from the previous system, are basically sound. Analysis in the SBC suggests that the current solvency margin does not reflect the underlying company risk profiles in the nonlife insurance sector.

49. **Concerns raised in the previous FSAP about the independence of the supervisory process remain.** The location of regulatory development in Hacienda runs contrary to full observance of international standards. Further steps to enhance the political independence of the regulatory process should be pursued through administrative means, such as: (1) implementing transparent processes for regulatory development; and (2) allowing the SBC greater budget flexibility on a fee recovery basis with an associated process of industry consultation.

50. **Efforts should be made to develop the sector's technical capacity.** These include ensuring sound regulation of change of control, establishing supervisory linkages for exchange of information with foreign supervisors, and making anticipatory changes to resolution regulations so as to provide a full "tool kit" as a precautionary measure.

IV. Corporate Sector Vulnerabilities

A. Financing of the Corporate Sector

51. **Financial conditions of the corporate sector have improved over the last four years as a result of a sustained recovery of economic activity and lower interest rates, but vulnerabilities remain.** Average profitability, as measured by the return on assets of the median firm, has returned to its pre-crisis levels but earnings remains low and unevenly distributed. As a consequence, a large number of firms still appear unable to meet their debt service obligations notwithstanding a restrained degree of leverage.

52. **Companies have reduced their exposure to external debt inducing a further reduction of their already modest degree of leverage.** During the last four years, reliance on bank credit declined in real terms in favor of retained earnings and supplier credit while equity mobilization has been virtually nonexistent. Market sources report that only large exporting or importing corporations use foreign exchange denominated debt.

53. **The recovery has been uneven across sectors.** Accounting data suggests that the extent of the recovery has been different between the tradable and nontradable sector, between large and small firms, across sectors and between listed and unlisted companies. The tradable sector outperforms the nontradable sector, mainly because of a recovery, in large part attributable to a real depreciation in the post-crisis years. Larger companies with adequate resources appear to have undertaken complex restructuring processes, under the impulse of adverse circumstances, gaining efficiency as well as benefiting from a lower cost of finance.

54. **The quality of corporate sector financial information remains a point of weakness to be addressed with high priority.** Further convergence toward international accounting standards, more stringent auditing practices, and effective regulatory enforcement are required to overcome limitations and inconsistencies in reported corporate financial information. These deficiencies currently help to undermine the diagnosis of existing weaknesses across firms and sectors. The regulatory effort should be complemented by training programs to promote professional skills in areas related to corporate sector life such as financial analysts, and insolvency appraisers. While the Colombian authorities should be commended for their remarkable effort to collect corporate accounting data in an easily accessible electronic format, additional improvements should be considered, such as creating a single dataset with information from listed and unlisted firms. The quality and reliability of available data will also facilitate their effective usage. In this context, a further strengthening of the ongoing dissemination and publicity of corporate sector information should complement the reform of accounting practices.

B. Corporate Sector Governance

55. **Market liberalization has partially transformed business groups into more focused, professionally managed and transparent operations.** However, corporate ownership is generally concentrated among a few, familiar in nature, and business groups with pyramid structures and cross shareholdings are frequent. Until the early 1990s, the enforcement of contracts through the judiciary was weak, information asymmetries were severe, and external financing was limited and expensive. Limits to capital mobility and to international trade provided incentives to domestic diversification of large groups, as well as shelter from foreign competition. Such a system fostered both vertical and horizontal integration. Conglomerates helped to mitigate the cost of market frictions, while pyramidal structures with a holding company wholly owned by the founding family at the apex of the pyramid, and cross shareholdings between companies affiliated to the group were efficient corporate structures in this environment. Moreover, institutional investors, acting in a fiduciary capacity, should disclose their overall corporate governance and voting policies with respect to their investment, including the procedures that they have in place for deciding on the use of their voting rights.

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	(Percent)						
	1998	1999	2000	2001	2002	2003	2004 2/
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Return on average equity	...	-32.6	-20.7	1.1	9.6	17.0	23.4
Return on average assets	...	-3.5	-2.3	0.1	1.1	1.9	2.7
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Sources: Superintendencia Bancaria; IFS; and Fund staff estimates.

1/ Excluding credit unions and public sector special institutions (IOE).

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3/ Market risks requirements, effective only as of 2001, are weighted 60% until 2003, 80% in 2003, and 100% thereafter.

4/ Loans past-due 90 days or more (120 days or more in the case of mortgages)

5/ Loan data includes leases as of 2004.

6/ Liquid assets include cash, deposits, and securities held for trading.

7/ Customer deposits used as proxy for short-term liabilities.

IMPLEMENTATION OF FSAP 2000 RECOMMENDATIONS

Recommendations	Status (1)
A. Systemic liquidity arrangements	
• Enhance the scope for market determination of central bank intervention rates.	FI
• Establish an arrangement to swap bank holdings of bank assets against tradable government securities.	NI
• Establish contingency plans to deal with small credit institutions that are exposed to liquidity pressures.	NI
B. Payment system risk management	
• Further encourage the development of the RTGS system.	FI
• Introduce measures to limit settlement risk in the check clearing system.	FI
C. Housing sector issues	
• Limit debt relief to debtors that are current in their payments and announce no further relief.	FI
• Adjust the interest rate insurance scheme to limit market distortions and strengthen hedging incentives.	
• Develop a contingency plan to deal with savings and loan institutions.	FI
D. Public bank restructuring	
• Tighten management of public banks, with the assistance of international investment bankers and reputable, professional administrators.	PI
• Consider the introduction of an ad-hoc monitoring committee.	NI
• Enhance the tradability of recapitalization bonds.	FI
E. Private bank recapitalization plan	
• Subject recapitalized banks to special inspection and monitoring program.	FI
• Introduce an explicit arrangement to recapitalize FOGAFIN in the event of losses.	FI
F. Corporate debt restructuring	
• Limit the scope for abuses in the classification of restructured debts.	NI
G. Bank supervision	
• Strengthen procedures to review banks' loan classification procedures and internal risk management.	PI
• Strengthen on-site inspection procedures and the training of on-site inspectors.	PI
• Introduce additional capital requirements for market risk.	FI
• Consider prudential measures to strengthen the resilience of the banking system to future macroeconomic shocks and limit the amplitude of credit cycles.	PI
H. Framework for bank resolution	
• Introduce regulations to implement a system of prompt corrective actions.	FI
• Implement FOGAFIN's draft organic statutes.	FI
• Review bankruptcy and tax legislation to encourage debt restructuring and facilitate assets recovery.	NI
I. Capital market development	
• Develop a comprehensive development strategy for capital markets and financial intermediaries.	PL
• Take measures to encourage long-term investments by pension funds.	PL
• Provide greater protection to mutual fund investors.	PL
• Review role of foreign investors and capital controls in new economic environment.	PL
• Strengthen the government securities market.	PL
• Promote the development of capital markets' infrastructure and enhance market transparency.	PL
• Initiate in-depth study of corporate sector with the aim of enhancing transparency and governance.	NI
• Undertake study to identify all discrepancies between the Colombian accounting standards and International Accounting Standards, and take measures to correct them.	PI

(1) FI=Fully Implemented; NI=Not Implemented; PI=Partially Implemented; PL=Pending Legislation

Summary Assessments of Observance of Standards and Codes

A. Insolvency and Creditor Rights

56. **The framework for insolvency procedures and the protection of creditor rights was extensively reformed in 1999, in order to accelerate the very protracted *Concordato* proceedings under the previous law.** Law 550 on reorganization was introduced in an emergency context, and approved under pressure to protect distressed debtors' interests. It is excessively tilted against creditors and, more specifically, against financial creditors' rights, providing a potentially harmful effect on bank lending and on the financial deepening of the Colombian economy. Improved economic conditions provide an opportunity to revise some aspects of the legal framework in order to reestablish a balanced approach to insolvency procedures. Individual actions for the collection of monies need to be reformed. The current project of reforms of all insolvency laws before Congress, and the widespread movement toward reform of laws on individual actions, provide a clear opportunity to incorporate international standards into Colombian law.

57. **The Colombian legal system provides sophisticated and varied protections of creditor rights in individual proceedings and advanced procedures for their registration but enforcement proceedings for both unsecured and mortgage creditors are inefficient and have caused a severe backlog of cases in saturated commercial courts.** Land and movable registries should be centralized and automated. Individual proceedings are plagued by the lack of appropriate accelerated procedures toward the collection of funds for both secured and unsecured creditors.

58. **Two main sources of ineffectiveness of the insolvency system stand out.** First is the laxity of prerequisites for restructuring agreements, which may eventually lead to the failure of the restructuring plan and to liquidation. The weakness of the restructuring procedure are to a large extent related to the following: (i) the shareholders' right to sit among the creditors with voting rights and (ii) to the violation of the priority rules of secured and unsecured creditors. Second, delays in insolvency procedures do not allow companies to rapidly reorganize or to be liquidated. Market practitioners have indicated that the resolution of the creditors claims may take up to two years, against the four months prescribed by the law.

59. **Confidence on the insolvency resolution procedures would increase were the role of Superintendent of Companies were be better adapted to its role of adjudicator of rights.** Given his jurisdictional functions the Superintendent of Companies should be granted independence. If the Superintendent is to make final decisions in insolvency matters, he should be granted the same independence as members of the Judiciary.

B. IOSCO Objectives and Principles of Securities Regulation

60. **Private capital markets have developed somewhat but continue to be characterized by low liquidity and insufficient depth.** This is probably attributable to the scarce supply of investment securities by local corporations, and deficiencies in clearance and

settlement systems, in addition to investment restrictions, issuance costs, taxation and the lack of fixed income hedging instruments. Most resources are channeled through the banking sector, while capital markets have still not become an alternative financing source for the private sector. Meanwhile, the secondary market liquidity lags behind comparable countries, especially in equity. This limitation is attributable to structural factors and some lags in market infrastructure. The government debt market has developed substantially.

61. **The modernization of the regulatory framework for securities markets is key to increase liquidity, to stimulate investment and to promote economic growth.** To create an efficient institutional framework, the securities regulatory regime is under review and there are many substantial changes underway regarding some essential factors such as suitable regulations, supervision capable of enforcing the regulations and the implementation of international standards. The regulatory framework is being amended toward best international practices, placing a special emphasis on protecting investor's rights, promoting market efficiency, integrity and trustworthiness among parties, and preventing systemic risks.

62. **The authorities are currently working on important reforms to reinforce their supervision and watchdog capabilities.** The supervisory authorities are also making progress to eliminate all regulatory arbitrages in all activities of the securities market that creates a lack of clarity of roles and supervisor functions overlap. A review of accounting and auditing standards and procedures used in Colombia is needed, as well as a program to adopt international financial reporting standards for listed corporations.

C. CPSS Core Principles for Systemically Important Payment Systems

63. **The draft of the securities markets law, currently in Congress, would provide a boost to local markets development.** The draft addresses most of the weaknesses identified in the legal framework for the payment system and improves compliance with CPSS standards. It covers issues such as the legal validation of multilateral netting, the protection of the system against bankruptcy procedures, settlement finality, protection of collateral arrangements, pledge, segregation of accounts, the legal definition of repos, central counterparties, and novation. It also extends this legal basis for funds and foreign exchange settlement systems. However, it does not address the lack of legal basis for the BRC's oversight function.

64. **The check system has significantly reduced its "systemic importance" but the BRC should continue its effort to reduce the use of checks among intermediaries and broaden the use of electronic payments.** The high value of some of the checks settled and the fact that this instrument is sometimes used by financial intermediaries to settle payments confirm that additional efforts to encourage electronic payments are needed.

65. **The BRC should seek clear legislative authority for the oversight of clearance and settlement systems**. This would provide the central bank with the legal authority to ensure the development and operation of payment mechanisms that effectively contribute to the integrity, efficiency and safety of all financial markets and the operation of monetary policy. The BRC should disclose publicly its objectives relating to all significant payment system matters along

with its implementation strategies. To this end, the central bank should provide guidance to private sector organizations on the governance, day-by-day management, the diminishing of risks, and the policies that must be satisfied by all transactions. The BRC should continue to play an active role in leading the payments system reform in the country.

66. **Principal risk should be eliminated in systems operated or owned by the stock exchange through the settlement of all operations on a delivery-versus-payment basis.** The supervisory function over settlement should be strengthened to ensure proper funds delivery. Settlement of stocks should include a settlement guarantee system or some kind of loss-sharing arrangement. Authorities and regulators must continue to encourage the use of electronic money transfers for settlement of the cash leg of securities transactions.

67. **The SVC's responsibilities on the oversight of the securities settlement systems should be included in the draft securities market law.** The SVC should ensure that sufficient resources are devoted to this function. Lastly, it is recommended that the BRC and the SVC play a leadership role in conforming to a cooperative forum for improving the payment and securities settlement system.

D. Summary Assessment of AML/CFT

68. **In October 2004, GAFISUD conducted a mutual evaluation of Colombia to assess compliance with the FATF 40 plus 8 Special Recommendations on AML/CFT.** GAFISUD has provided the mission with a copy of the evaluation report and a summary of key findings arising from the mutual evaluation, and is currently drafting the ROSC.[11] The summary indicates that the Colombian authorities are deeply committed to combating money laundering and have achieved a significant number of convictions. Colombian AML legislation makes money laundering an autonomous offense and covers most serious predicate offenses, although it should also incorporate smuggling and piracy among them. With respect to confiscation of illicit property, Colombian legislation is among the few that provide for "*extinción de dominio*" (domain extinction) which facilitates the forfeiture of illicit property through a process separate from money laundering criminal procedures. However, Colombia has not ratified the UN Convention for the Suppression of Financing of Terrorism, and there is no specific legislation that criminalizes the financing of terrorism.

69. **The financial intelligence unit (*Unidad de Información y Análisis Financiero*) is one of the leading authorities in AML/CFT controls in Colombia with adequate powers and systems.** The regulatory and supervisory elements of AML/CFT are mainly led by the financial supervisory agencies, the BRC, and the revenue and customs (*Direccción de Impuesto y Aduanas Nacionales*) authorities. The SBC recently overhauled its AML/CFT regulations and

[11] The ROSC is expected to be sent for IMF/World Bank proforma review around April 2005.

is adapting its supervisory practices accordingly, while governmental oversight of other sectors subject to AML obligations require additional efforts.

Libertad y Orden

Ministry of Finance and Public Credit
Republic of Colombia

Bogotá D. C., May 16, 2005

Comments on "Colombia – Financial System Stability Assessment"[1]

In September 2004 a joint IMF/World Bank mission visited Colombia for the purpose of updating the Financial System Stability Assessment, undertaken in 1999.

The aim of the 1999 assessment was to analyze the causes of the financial crisis Colombia was then experiencing, as well as the lessons to be drawn to reduce the risk of similar events in the future. The focus of the update mission, was to expound three topics that will contribute to financial sector development: first, the strengths and weaknesses of the leading financial intermediaries; second, the challenges facing regulators; and, third, the legal obstacles to financial deepening.

The new mission report provides a timely and useful evaluation of the current status of the financial system, following the crisis at the end of the 1990s. The report notes that the financial sector seems relatively stable and able to absorb possible adverse shocks. It also points out the increased capitalization of the banking system, advances in financial legislation, and improvements in regulation and supervision. However, the report also mentions a number of major vulnerabilities in the financial system, some of which need further clarification.

The assertions concerning the overvaluation of assets ignores the progress made by the government, through the superintendencies and the Banco de la República, in the development of a system for valuing investments at market prices (INFOVAL), which corrected any possible problem of overvalued assets. The valuation methodology designed for that purpose and the information submitted by the various institutions in the implementation of the methodology are constantly monitored by the responsible agencies.

On this point, specific mention should be made of the progress achieved by the Banking Superintendency of Colombia (SBC) toward improving risk measurement and management in the banking sector. This is the case, for example, with regulations governing the treatment of foreclosed assets (BRDPs). In fact, since 2001 it has been possible for institutions to develop a methodology to estimate expected losses on the sale of foreclosed fixed assets and to determine the provisions required for that purpose. External Circular 034 of 2003, for its part, contained specific information on the valuation, reporting, and provisioning of such assets.

1/ Joint comments of the Ministry of Finance and Public Credit, the Directorate General of Financial Regulation, the Banking Superintendency, the Superintendency of Securities, and the Banco de la República. Draft April 5 / 2005.

Regarding the comments about exposure to credit risk and the adequacy of provisions for nonperforming loans, it must be remembered that the SBC, with a view to strengthening the credit risk management criteria and the procedures for measuring such risk, has been working continually on the development of the SARC system, which provides a prospective and probabilistic measurement of credit risk (replacing ad hoc criteria) and its components (probability of default, exposure, and recovery rate). The SBC's policies in this area reflect a gradual, step-by-step approach, which, without overburdening financial institutions, allows for improvement of the measurement methodologies and the criteria for covering such risk. In fact, External Circular 052 of 2004 established a phased entry into force of the reference models and the institutions' own models, by type of portfolio and over a medium term horizon, as well as clearly pointing out alternatives for institutions with no internal models.

Moreover, on the subject of the adequacy of the capital requirements for market risk, it should be emphasized that for the regulatory and supervisory agencies, the identification and prevention of such risk is and has been important. In fact, changes made in the post-crisis regulation (Decree 1720 of 2001) included capital requirements to confront with potential losses resulting from market risks covering the entire balance, the cash ledger, and the bank ledger (interest rate risk, exchange risk, and price risk). In addition, the SBC is taking steps to refine the calculation of such risk, as well as the set of standards applicable to the cash operations of supervised institutions. These changes will improve investment valuation (diversify risk factors by term and type of security) and provide a better understanding of the interest rate and liquidity risk faced by banks that cover their assets with very short-term liabilities (primarily deposits). Efforts are also being made to improve the volatilities of the reference risk factors through econometric models better adapted to market conditions; the volatilities in the standard model are being revised and will be calculated quarterly in order to capture, in greater detail, its impact through the VaR.

Another aspect worth commenting on is the section designed to subject the financial system to extreme stress tests. The assumptions concerning the behavior of the variables included in these tests are too stringent for Colombia. Events such as the withdrawal of 25 percent of deposits from credit institutions, the inversion of the yield curve of sovereign bonds (sovereign debt default), the change in the slope of the yield curve, etc., are not characteristics of Colombia's economy.

For the above reasons, and with a view to contributing to this analysis, the SBC examined the results of these tests, in terms of both their methodological characteristics and their assumptions and results, and concluded that there were methodological limitations in the instruments used by the mission, which alter the conclusions. In any case, the SBC wishes to point out that the lack of information needed to duplicate the exercises may have an impact on its own conclusions.

In fact, concerning credit risk, the report based on the elasticity of a regression between portfolio quality and certain macroeconomic variables reveals that a decline in real GDP growth rate of

3 percent would generate an increase in the portfolio quality indicator to about 14 percent and, therefore, a decrease in the solvency ratio of credit institutions from 13.7 percent to 8.6 percent.

Based on the available information, the SBC duplicated the long- and short-term models described in the document, using the same variables, time series, and functional form. The results of the revision indicate the possibility of statistical problems in the models used by the mission that affect the quality of its conclusions. Moreover, the SBC conducted alternative stress tests using the default probabilities recorded in 1998,[2] applied to the portfolio balances recorded in December 2004. It was found that the impact of larger portfolio provisions on the solvency ratio would lead to a decrease in the ratio of 31 basis points, from 13.15 percent to 12.84 percent.

Stress Credit Risk Scenario
Simulation with the reference model for commercial loans
Outstanding Portfolio Balance as of December 2004

	Allowance for loan losses			**Solvency Indicator**		
	Dec. / 2004	**Stress Testing***	**Increase %**	**Dec. / 2004**	**Stress testing***	**Variation**
Banco de Bogotá	186,892	287,458	54.81%	13.14	11.96	1.18
Citibank	3,273	30,961	133.27%	14.12	13.58	0.54
Banco de Crédito	30,119	70,105	132.76%	11.9	9.95	1.95
Bancolombia	267,156	310,817	16.34%	13.31	12.95	0.36
BBVA	258,377	284,392	10.07%	11.11	10.63	0.48
Banking System	**1,959,661**	**2,204,083**	**12,47**	**13.15**	**12.84**	**0.31**

* *As indicated in the text, this stress scenario assumes that default probabilities of the portfolio are equal to those registered in 1998*

Concerning the capital adequacy of credit institutions to hedge against market risk fluctuations, it was again found that the methodology used by the mission differs from the VaR model used by the SBC and ignores risk diversification. The SBC recalculated these risks, correcting for methodological differences and appropriately incorporating the derived impact on the solvency ratio, and found that the effect of interest rate changes on market VaR, without accounting for any impact on capital or on the value of risk-weighted assets, would not cause the solvency ratio to fall below 9 percent on average for the system[3].

[2] Due to the fact that GDP fell by 4.5 percent in 1998, this test uses more stringent economic growth assumptions than the one used by the mission.
[3] Although it could happen in some individually institutions.

Market Risk Impact on Solvency
Stress Scenarios using FSAP and SBC Methodology
Data as of June 2004(1)

Risk Market Impact Evaluation (Without affecting PT and APNR)				
	Parallel Change in Interest Rates (a)	*Inverted Yield Curve* (b)	*Steepened Yield Curve* (c)	August 2002 Crisis (d)
Solvency Reported	**13,79%**			
Total Stressed Solvency (2)	12,58%	11,43%	10,39%	10,56%
Solvency Reduction (percentage points)	-1,21%	-2,36%	-3,40%	-3,23%
Capital Requirements Million COP	993.701	2.139.391	3.384.715	3.163.396
Entities under 9%	**2**	**6**	**9**	**4**

Notas:
(1) Does not include Megabanco because at the time of the visit of the Mission, the bank had not transmitted the information about market risk as of June 2004. Multifinanciera was not included eithe, as it was an institution on voluntary liquidation on 2004.
(2) It includes corrections such as calculating the Diversified VeR (includes correlations between risk factors)
a) An increase in the Probable Maximum Variations (herein PMV) in some domestic interest rates up to 400 basis points (Parallel Change in Interest Rates)
b) A scenario like the one registered in the crisis of August 2002. (The PMV and correlation matrix of the risk factors registered then are used)
c) PMV decreasing (Inverted Yield Curve)
d) PMV increasing (Steepened Yield Curve)

A final aspect regarding the stress scenarios is the one related to liquidity risk. According to the report, the analysis gaps at 1 and 3 months indicate that, taken as a whole, banking institutions do not have a cushion to help them deal with a drop in their deposits. Although the SBC could not clearly determine how the mission handled this risk in its calculations, it duplicated the calculation of the gaps at 3 months and the results were not consistent with those presented by the mission. One explanation for this situation concerns the impossibility of establishing the distribution of flows in the maturity bands used by the mission.

a) SBC
- Gap for 3 months = [Assets with 3 months maturity + contingent debts] – [liabilities with 3 months maturity + contingent debts]
- 3 month gap = $\dfrac{\text{Gap for 3 months}}{\text{Net Liquid Assets}^{4}}$

[4] Disposable funds + Net Interbanking Funds + resale agreements - repurchase agreements – negotiable securities.

b) Mission

$$\text{- 3 month gap} = \frac{\text{Non liquid assets}^{5} - \text{3 month liabilities}}{\text{Total Liquid Assets}^{6}}$$

There are other comments concerning the document submitted by the mission that are worth noting. Mention should be made of the mission's observation that on-site supervision and off-site supervision are areas in which progress has been modest or nonexistent. On this subject, it is necessary to point out that in order to strengthen those aspects, the Directorate of Supervision was created by Decree 1577 of 2002, establishing supervision policies, procedures, and techniques. In addition, the On-Site Supervision Management System (ASIS) entered into service. This software is used to automate and monitor the progress of the Annual Schedule of Inspections carried out by the SBC. This computer tool includes modules for organizing and monitoring the planning, execution, reporting, and results of inspections. It is also used to make queries about the various aspects of the tasks of on-site supervision carried out by the various units of the SBC.

It should also be clarified that the functions of the tax auditor and the authorization that the Banking Superintendency grants for consideration of the financial statements by the respective shareholders meetings and their subsequent publication are different. The latter is exercised on the basis of its nature and objectives. Conversely, the tax audit office issues its opinion or report on the financial statements of the company, and thus performs an ongoing task related to its financial information. Hence the vital importance of the broad, timely, complete, and integral cooperation of the tax auditor with the supervisory authorities, specifically the Banking Superintendency, which does not imply that duties and responsibilities of each are un-bounded or that they do not differ among them.

Moreover, the report states that the lack of liquidity and depth of the private capital market is attributable in part to "clearing and settlement problems." However, this statement ignores the progress achieved in this area, such as the inter-institutional work of the Ministry of Finance and Public Credit, the Superintendencies of Banking and Securities, and the Banco de la República, in the money market FIRST project, which is supported by the World Bank. In addition, and as stated in the IOSCO assessment, the problems encountered are addressed in the draft Securities Market Law, which has been submitted to the Congress.

[5] Obtained as the residual of Total Liquid Assets – Liquid Assets
[6] Deposits + interbank + negotiable securities

It should also be remembered that when implemented the Securities Market Law will undoubtedly strengthen the market regulatory system and lay the foundation for other structural and normative developments which the market needs to enhance its liquidity and depth. The law also contains clarifications concerning the supervision of all market transactors and participants and addresses the concerns expressed in another comment in the document on the need to identify the lead supervisor for independent securities brokers and brokers related to banks.

On the subject of oversight of the payments and clearing system, the draft Securities Market Law reaffirms the regulatory authority of the Banco de la República over the high-value payments system, contrary to the report's comment on lack of clarity concerning oversight authority in the area of payments and clearing.

Another important aspect is related to the recommendation to undertake an in-depth study of the corporate sector with the aim of enhancing transparency and governance. This ignores the efforts that the Superintendency of Securities has been making to implement and enforce corporate governance principles among issuers (currently more than 100 issuers have adopted CG codes), which has enabled the sector to attain a higher level of development in this area than the rest of Colombian industry. Equally important are the concrete gains achieved through Resolution 275 of 2001 and the incorporation of a number of principles in the draft Securities Market Law, as well as programs being developed with Confecámaras and the Colombian Securities Exchange regarding the "comply or explain" concept.

The importance ascribed to the subject "Framework for bank regulation" ignores the progress achieved with the issuance of Decree 2211 of 2004, which focuses on expediting the settlement process. Among other considerations, this decree (i) expands the mechanisms for informing the public about an intervention measure, (ii) clarifies certain aspects related to the Banking Superintendency's optional stay of payments order, (iii) incorporates rules on administrative intervention and explains the concept of the Special Agent, as well as the requirements governing the Agent's appointment, compensation, duties, and powers; (v) includes provisions related to the assignment of lease and trust agreements, with a view to updating the rules in light of certain provisions of Law 795 of 2003 and the regulatory needs expressed by some liquidators of institutions of this type; and (vi) *inter alia*, creates various instruments for use in finalizing pending issues of institutions subject to intervention.

In addition, we believe it important to point out that the 15 percent cost of administering the contribution referred to in the document is equal to 1.5 percent of the members' wages, which is below the Latin American average. The changes made in March 2005 with a view to selling what is now Granbanco-Bancafé should not be lost from sight.

Finally, we would like to stress the importance of the FSSA, which provides a timely and useful evaluation of the current status of the financial system, following the crisis at the end of the last decade, as mentioned at the beginning of this document.